1969

Uniform certified public accountant examinations, May 1966 to November 1968; Uniform CPA examination questions, May 1966 to November 1968

American Institute of Certified Public Accountants. Board of Examiners

UNIFORM CPA EXAMINATION QUESTIONS

MAY 1966 TO NOVEMBER 1968

UNIFORM CERTIFIED PUBLIC ACCOUNTANT EXAMINATIONS

Prepared by the Board of Examiners of the
American Institute of Certified Public Accountants
and adopted by the examining boards of
50 states, the District of Columbia,
Puerto Rico, Guam, and the Virgin Islands.

MAY 1966 to NOVEMBER 1968

Published by the
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
666 Fifth Avenue, New York, N. Y. 10019

FOREWORD

This volume, the fourteenth of its kind, includes the text of the Uniform Certified Public Accountant Examinations, prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of 50 states, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands. The examinations from May 1966 to November 1968, inclusive, are included in this volume. The thirteen prior volumes contain all the examinations since 1917.

While the American Institute of Certified Public Accountants does not publish official answers, it is felt that students may be benefited by a review of the unofficial answers published twice a year as a supplement to THE JOURNAL OF ACCOUNTANCY. Consequently, we are publishing simultaneously with this volume a companion book entitled *Unofficial Answers to the Uniform CPA Examinations, May 1966 to November 1968,* which contains answers to the questions included in this volume.

JOHN LAWLER, *Administrative Vice President*
American Institute of Certified Public Accountants

April 1969

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EXAMINATION IN ACCOUNTING PRACTICE—PART I

May 18, 1966; 1:30 to 6:00 p.m.

All problems are required.

Number 1 (Estimated time—40 to 50 minutes)

Instructions

The following questions pertain to Doe Corporation, a manufacturer. You have been engaged to prepare Doe Corporation's Federal income tax return on the accrual basis for its fiscal year ended December 31, 1965.

On a separate answer sheet write the letter of your answer choice for each of the following questions. The answers should be selected in accordance with the current Internal Revenue Code and Regulations. Select only one answer for each question.

An example of the manner in which the answer sheet should be marked is shown in the following illustration:

Question

XX Doe Corporation paid the following salaries during 1965:
$30,000—John Doe, President
$20,000—George Doe, Vice President
$18,000—John Smith, Sales Manager
$12,000—John Jones, Plant Manager
Doe Corporation should report compensation of officers in the amount of:
a. $30,000.
b. $50,000.
c. $68,000.
d. $80,000.
e. None of the above.

Answer Sheet

XX b.

Questions to be Answered

1. During 1965 customers deducted $48,000, which included $8,000 applicable to 1964 sales, from their remittances for cash discounts. At December 31, 1965 a reserve of $9,000 was established for anticipated cash discounts on 1965 sales; no such reserve was used at the end of 1964. Allowances made in 1965 for returned or defective merchandise amounted to $14,500. On January 20, 1966 the Corporation made an allowance of $600 for defective merchandise shipped in 1965. For 1965 the Corporation would report deductions from sales of

a. $54,500.
b. $62,500.
c. $63,100.
d. $71,500.
e. None of the above.

2. Assume that Doe Corporation's 1965 taxable income is $8,000 before inclusion of the following dividend income:

$10,000—General Motors Corporation
1,700—Quebec Power Corporation (net of 15% withholding tax)
$11,700—Total cash received

Doe Corporation's dividends received deduction for 1965 is

a. $ 1,500.
b. $ 6,800.
c. $ 8,500.
d. $10,200.
e. None of the above.

3. Assume the same facts in "2" above and further assume that Doe Corporation's tentative Federal income tax is $2,200. Doe Corporation's credit for taxes paid to a foreign country is

a. $ 80.00.
b. $200.00.
c. $244.44.
d. $300.00.
e. None of the above.

4. A schedule of Doe Corporation's interest income for 1965 follows:

$150—Mid-City Bank certificate of deposit
$200—New Jersey Turnpike Bonds
$250—St. John Church Bonds
$600—Terminal Railroad Coupon Bonds, including $300 of unclipped matured coupons. (Interest on the bonds is not in default.)

For 1965 Doe Corporation should report interest income of

a. $ 450.
b. $ 700.
c. $ 750.
d. $1,000.
e. None of the above.

5. An idle warehouse was rented by Doe Corporation to Rio Corporation on July 1, 1964 under a 3-year lease providing for monthly rent of $300 and a deposit of $300 to be applied against the final month's rent. On June 1, 1965 Rio paid Doe $700 to cancel the lease as of July 1, 1965; the deposit was applied to the June rent. Commencing July 1, 1965 Doe began using the warehouse for its own purposes. For 1965 Doe Corporation should report (before deductions for depreciation, expenses, etc.):
   a. Rental income of $2,200.
   b. Rental income of $2,500.
   c. Rental income of $1,500 and a long-term capital gain of $700.
   d. Rental income of $1,800 and a long-term capital gain of $700.
   e. None of the above.

6. During 1965 Doe Corporation had the following miscellaneous cash receipts:
   $ 500—Sale of scrap metal.
   $7,000—Damages for infringement of a patent.
   $ 300—Duplicate payment on December 29, 1965 of an invoice by a regular customer.

   Doe Corporation should report other income of
   a. $ 500.
   b. $ 800.
   c. $7,500.
   d. $7,800.
   e. None of the above.

7. The following commissions were paid by Doe Corporation during 1965:
   $78,000—To salesmen for 1965 sales.
   $13,000—Advances to junior salesmen against future sales commissions. The salesmen are not obligated to return the advances if they leave the company before the commissions are earned.
   $ 3,000—for arranging for the purchase of a future plant site.

   Total commissions to be deducted as salaries and wages in 1965 would be
   a. $78,000.
   b. $81,000.
   c. $91,000.
   d. $94,000.
   e. None of the above.

8. An analysis of Doe's Repairs account follows:
   $35,000—Miscellaneous repairs.
   $ 5,000—Provision for biennial heavy repairs to kiln.
   $ 4,000—Concrete lining added to walls of a warehouse. The life of the warehouse was not prolonged and the market value was not increased as a result of the work.

   Doe Corporation should claim repairs of
   a. $35,000.
   b. $39,000.
   c. $40,000.

d. $44,000.
e. None of the above.

9. Doe Corporation is on an allowance or reserve basis for bad debts for financial reporting purposes and on a specific write-off basis for tax purposes. Provisions for bad debts during 1965 totaled $1,800. The balances in the Allowance for Bad Debts account were $2,900 at January 1, 1965 and $1,700 on December 31, 1965. Bad debt write-offs during the year included $800 applicable to 1964 sales. Doe Corporation also entered into a creditors' agreement on January 15, 1966 to accept a 25% settlement on a $400 delinquent account. No portion of this delinquent account was written off in 1965. For 1965 Doe Corporation would claim bad debts of
a. $2,200.
b. $3,000.
c. $3,100.
d. $3,400.
e. None of the above.

10. An analysis of the Taxes Paid account follows:
$23,000—Social security taxes.
$ 9,000—City real estate taxes.
$ 6,000—Additional Federal income taxes assessed after revenue agent reviewed 1963 income tax return.
$ 100—Federal stamp taxes paid in connection with sale of real estate.
Doe Corporation should claim a deduction for taxes in the amount of
a. $32,000.
b. $32,100.
c. $38,000.
d. $38,100.
e. None of the above.

11. During 1965 the following items were charged to the Interest Expense account:
$17,000—Interest on mortgage payable.
$ 400—Interest on additional income taxes assessed for 1963.
$ 700—Interest on bank loan to finance installation of new machinery. Bank loan was refinanced when installation was completed.
$ 500—Interest deducted by bank from proceeds of Doe Corporation's 60-day note signed December 1, 1965.
The maximum amount of interest expense that Doe Corporation can deduct for 1965 is
a. $17,400.
b. $17,650.
c. $18,100.
d. $18,600.
e. None of the above.

12. The contributions deduction of a corporation is limited to a percentage of its taxable income computed without regard to the contributions deduction. This contribution limitation percentage is

- a. 3%.
- b. 5%.
- c. 20%.
- d. 30%.
- e. None of the above.

13. A corporation may treat 1965 contributions in excess of the contributions limitation as

- a. A carryover to the next two years.
- b. A carryover to the next five years.
- c. A carryback to the preceding three years and a carryover to the next five years.
- d. A carryback to the preceding five years and a carryover to the next five years.
- e. None of the above.

14. Doe Corporation incurred the following theft or casualty losses which were not covered by insurance:

$ 500—Cash shortage discovered in 1965 in audit of 1964 transactions. Theft loss was not claimed for 1964 because employee promised to make restitution, but he failed to do so.

$1,000—Value of trees lost in fire that swept building site in July 1965.

$5,000—Value of portion of land fronting on a river that was washed away in a flood on February 15, 1966. Flood region was declared a disaster area.

The maximum amount of theft and casualty losses which Doe Corporation may claim for 1965 is

- a. $6,500.
- b. $6,400.
- c. $1,500.
- d. $1,000.
- e. None of the above.

15. Doe Corporation was organized on July 1, 1963 under an unlimited time charter. Organization expenses of $6,000 were incurred. On July 1, 1965 management decided to make a lump-sum write-off of this $6,000 intangible asset. For 1965 this write-off can be claimed as a deduction in the maximum amount of

- a. $ 600.
- b. $1,200.
- c. $3,000.
- d. $6,000.
- e. None of the above.

16. Doe Corporation operates a mine to obtain a mineral for its manufacturing process. The mine property was purchased in 1958 for $500,000 and was esti-

mated to contain 250,000 tons of the mineral. Taxable income from the mine property, computed without regard for the depletion allowance, amounted to $100,000 for 1965. In 1965 25,000 tons were mined and had a market value of $8 per ton. The percentage depletion rate is 15%. In prior years total depletion of $490,000 was claimed for income tax purposes. For 1965 Doe Corporation should claim depletion of

a. $10,000.
b. $30,000.
c. $40,000.
d. $50,000.
e. None of the above.

17. An analysis of the Advertising account follows:

$ 500—Cost of advertisement that urged citizens to vote in a national election.
$30,000—Sales literature.
$12,000—Cost of 1965 advertising campaign that is expected to have a three year benefit, including 1965.
$ 5,000—Preparation costs for special spring 1966 advertising campaign. Costs include 1965 cash payment of $2,000 and accruals of $3,000.

$47,500—Total

For 1965 Doe Corporation should deduct advertising expense of

a. $34,500.
b. $36,500.
c. $42,500.
d. $47,500.
e. None of the above.

18. The following assets were acquired during 1965:

$20,000—Construction cost of new maintenance building. Estimated life is 20 years.
$ 6,000—New delivery truck. Estimated life is 3 years.
$10,000—Cost of new production press constructed by Doe Corporation employees. Estimated life is 10 years.

Before application of any limitation imposed by its liability for Federal income taxes, Doe Corporation can claim an investment credit of

a. $ 140.
b. $ 840.
c. $1,540.
d. $2,520.
e. None of the above.

19. Assume that Doe Corporation's 1965 income tax liability is $2,100. To avoid payment of interest on the unpaid balance, the tax must be paid as follows:

a. $2,100 by April 15, 1966.
b. $1,050 by April 15 and $1,050 by June 15, 1966.
c. $1,400 by April 15 and $700 by June 15, 1966.
d. $700 by April 15 and $1,400 by June 15, 1966.
e. None of the above.

20. Doe Corporation must file a declaration of estimated tax for 1966 if it can be reasonably expected that, for 1966,

a. Its net income, if any, will be in excess of any net operation loss deduction carryover.
b. Its total income will exceed $100,000.
c. Its taxable income will exceed $100,000.
d. Its income tax liability will exceed $100,000.
e. None of the above.

Number 2 (Estimated time—40 to 50 minutes)

Ajar Company operates a public warehouse and has applied to a lending institution for a loan to expand its facilities. Ajar Company maintains its accounting records and files its Federal income tax return on a cash receipts and disbursements basis. The lending institution has requested financial statements prepared on the accrual basis and examined by a CPA.

Ajar Company's December 31, 1965 general ledger trial balance follows:

Ajar Company
GENERAL LEDGER TRIAL BALANCE
December 31, 1965

	Debit	*Credit*
Cash	$ 145,000	
Investments	425,000	
Property, plant and equipment	1,200,000	
Allowance for depreciation		$ 350,000
Payroll taxes withheld		12,000
Capital stock		1,000,000
Retained earnings		318,000
Rental and service income		400,000
Operating expense	200,000	
Insurance	30,000	
Administrative expense	70,000	
Investment income		15,000
Federal income tax paid	25,000	
	$2,095,000	$2,095,000

Details of unrecorded accruals and other information follow:

	December 31 1964	December 31 1965
Accounts receivable—rents and services (Includes doubtful accounts totaling $700 at December 31, 1965. All doubtful accounts were for 1965 services.)	$ 27,000	$ 37,000
Rental deposits from lessees ($7,500 of 1965 amount was received in 1965 and recorded in Rental and Service Income; $600 of the 1964 amount was applied to final month rentals in 1965.)	2,100	9,000
Interest income receivable	1,000	2,600
Market value of investments (All investments are corporate bonds)	460,000	475,000
Accounts payable (operating expenses)	8,000	9,700

The amount in the Insurance account is a February 1 payment for insurance premiums: $6,000 for a one-year liability insurance policy and $24,000 for a three-year fire insurance policy. The coverage under both policies commenced on January 1.

Payroll Taxes Withheld includes employees' F.I.C.A. taxes of $800. Administrative Expenses includes a payment of $300 for 1964 employer F.I.C.A. taxes.

All prior year income tax returns (1964 and earlier) have been reviewed by taxing authorities and found to have been properly prepared. Assume that the income tax rate is 50%.

Required:

Prepare a worksheet for the preparation of financial statements on an accrual basis. Supporting computations including the computations of the income tax liability and deferred income taxes should be in good form. (Formal financial statements and journal entries are not required.)

Number 3 (Estimated time—40 to 50 minutes)

The Largo Manufacturing Company makes and sells a single product, VOSTEX, through normal marketing channels. You have been asked by its president to assist in determining the proper bid to submit for a special manufacturing job for the Aztec Sales Company. Below is the information you have collected.

1. The special job is for MOFAC, a product unlike VOSTEX, even though the manufacturing processes are similar.

2. Additional sales of MOFAC to the Aztec Sales Company are not expected.

3. The bid is for 20,000 pounds of MOFAC. Each 1,000 pounds of MOFAC requires 500 pounds of material A, 250 pounds of material B, and 250 pounds of material C.

4. Largo's materials inventory data follow:

Material	*Pounds in inventory*	*Acquisition cost per lb.*	*Current replacement cost per lb.*
A	24,000	$.40	$.48
B	4,000	.25	.27
C	17,500	.90	.97
X	7,000	.80	.85

Material X may be substituted for material A in MOFAC. Material X, made especially for Largo under a patent owned by Largo, is left over from the manufacture of a discontinued product, is not usable in VOSTEX, and has a current salvage value of $180.

5. Each 1,000 pounds of MOFAC requires 180 direct labor hours at $3.00 per hour (overtime is charged at time and a half). However, Largo is working near its two-shift capacity and has only 1,600 hours of regular time available. The production manager indicates that he can keep the special job on regular time by shifting the production of VOSTEX to overtime if necessary.

6. Largo's cost clerk informs you that the hourly burden rate at normal production is as follows:

Fixed element	$ .20	per direct labor hour
Variable element	.80	per direct labor hour
Total hourly burden rate	$1.00	per direct labor hour

7. The bid invitation states that a performance bond must be submitted with the bid. A local agent will bond Largo's performance for 1% of the total bid.

Required:

a. Prepare a schedule to compute the minimum bid (i.e., the bid that would neither increase nor decrease total profits) that Largo Manufacturing Company may submit.

b. Largo's president also wants to know what his new competitor, Melton Manufacturing Company, probably will bid. You assume that Melton's materials inventory has been acquired very recently and that Melton's cost behavior is similar to Largo's. You know that Melton has ample productive capacity to handle the special job on regular time.

Prepare a schedule to compute the minimum bid (i.e., the bid that would neither increase nor decrease total profits) that Melton Manufacturing Company might submit.

Number 4 (Estimated time—50 to 60 minutes)

General ledger trial balances as of December 31, 1965 and 1964 for P Company and S Company follow:

	December 31, 1965			December 31, 1964		
	P Company	S Company	Combined	P Company	S Company	Combined
Cash	$ 21,100	$ 34,700	$ 55,800	$ 56,700	$ 25,800	$ 82,500
Accounts receivable	49,700	64,200	113,900	54,200	31,500	85,700
Inventories	46,600	64,400	111,000	49,800	41,400	91,200
Other receivables—current	41,300	22,400	63,700	32,300	15,500	47,800
Investment in S Company	178,400		178,400	178,400		178,400
Other investments	10,800	33,400	44,200	92,800	33,400	126,200
Land	18,200	15,000	33,200	28,700	15,000	43,700
Buildings	135,800	87,000	222,800	106,700	65,000	171,700
Equipment	61,000	45,000	106,000	48,000	45,000	93,000
Total debits	$562,900	$366,100	$929,000	$647,600	$272,600	$920,200

	December 31, 1965			December 31, 1964		
	P Company	S Company	Combined	P Company	S Company	Combined
Allowance for bad debts	$ 4,500	$ 3,900	$ 8,400	$ 4,100	$ 3,700	$ 7,800
Allowance for depreciation	69,500	50,600	120,100	41,300	31,200	72,500
Accounts payable	22,900	45,900	68,800	31,200	36,800	68,000
Notes payable	41,000	25,000	66,000	88,400		88,400
Dividends payable		14,000	14,000			
Other accruals	5,900	20,800	26,700	2,700	2,600	5,300
Income taxes payable	19,600	19,400	39,000	46,500	22,300	68,800
Bonds payable				30,000		30,000
Capital stock	175,000	75,000	250,000	175,000	75,000	250,000
Capital contributed in excess of par value	117,000	38,200	155,200	117,000	38,200	155,200
Retained earnings	87,400	48,800	136,200	62,300	38,700	101,000
Net income for year	20,100	24,500	44,600	49,100	24,100	73,200
Total credits	$562,900	$366,100	$929,000	$647,600	$272,600	$920,200

The following information is available:

1. P Company acquired 90% of the outstanding stock of S Company on January 2, 1964 in exchange for:

500 shares P Company Capital Stock; par value $50, market value $200	$100,000
Note payable due July 2, 1966	78,400
Total	$178,400

The above note payable due July 2, 1966 was paid on December 1, 1965.

2. In January 1965 P Company sold some "other investments" for $101,300 that cost $85,400. All investments are considered to be long-term investments. In March 1965 P Company sold a parcel of land for $18,800 that cost $10,500.

3. On June 30, 1965 P Company demolished an unneeded warehouse building that cost $18,900 and had a net book value of $5,400 on that date.

4. During 1965 P Company declared and paid cash dividends totaling $24,000. S Company declared a cash dividend totaling $14,000 on December 1, 1965 payable on January 10, 1966 to holders of record on December 15, 1965. The dividend receivable was recorded in P Company's Other Receivables account.

5. The P Company bonds, which had a maturity date of December 1, 1967, were retired in 1965 at a total consideration of $32,500 including $600 for accrued interest and $1,900 penalty for early retirement.

6. At December 31, 1965 P Company's account, Other Receivables, includes a $25,000 noninterest bearing note receivable from S Company. S Company's account, Accounts Receivable, includes $18,500 due from P Company for merchandise purchases. The P Company Inventories account includes intercompany profit of $5,000 arising from purchases from S Company.

7. The amounts for net income for the year are after all deductions; no expenses or income were recorded in the Retained Earnings accounts.

Required:

Prepare a formal consolidated statement of source and application of funds for P Company and its subsidiary for the year ended December 31, 1965 and a formal schedule of changes in consolidated working capital. All supporting computations, including the computation of consolidated net income, should be in good form.

Number 5 (Estimated time—50 to 60 minutes)

On April 15, 1966 fire damaged the office and warehouse of King Wholesale Corporation. The only accounting record saved was the general ledger from which the following trial balance was prepared:

King Wholesale Corporation
TRIAL BALANCE
March 31, 1966

Cash	$ 7,000	
Accounts receivable	27,000	
Inventory, December 31, 1965	50,000	
Land	24,000	
Building and equipment	120,000	
Allowance for depreciation		$ 27,200
Other assets	3,600	
Accounts payable		23,700
Other expense accruals		7,200
Capital stock		100,000
Retained earnings		47,700
Sales		90,400
Merchandise	42,000	
Other expenses	22,600	
	$296,200	$296,200

The following data and information have been gathered:

1. The fiscal year of the Corporation ends on December 31.

2. An examination of the April bank statement and cancelled checks revealed that checks written during the period April 1-15 totalled $11,600: $5,700 paid to accounts payable as of March 31, $2,000 for April merchandise shipments, and $3,900 paid for other expenses. Deposits during the same period amounted to $10,650, which consisted of receipts on account from customers with the exception of a $450 refund from a vendor for merchandise returned in April.

3. Correspondence with suppliers revealed unrecorded obligations at April 15 of $8,500 for April merchandise shipments, including $1,300 for shipments in transit on that date.

4. Customers acknowledged indebtedness of $26,400 at April 15, 1966. It was also estimated that customers owed another $5,000 which will never be acknowledged or recovered. Of the acknowledged indebtedness, $600 will probably be uncollectible.

5. The following insurance coverage was in effect at the date of the fire:

Insurance Company	*Amount of Coverage*	*Property Covered*	*Coinsurance*
A	$30,000	Inventory	80%
B	20,000	Inventory	70%
C	10,000	Inventory	None

6. The companies insuring the inventory agreed that the Corporation's fire loss claim should be based on the assumption that the over-all gross profit ratio for the past two years was in effect during the current year. The Corporation's audited financial statements disclosed the following:

	Year Ended December 31	
	1965	*1964*
Net sales	$400,000	$300,000
Net purchases	226,000	174,000
Beginning inventory	45,000	35,000
Ending inventory	50,000	45,000

7. Inventory with a cost of $6,500 was salvaged and sold for $3,000. The balance of the inventory was a total loss.

Required:

a. Prepare a schedule computing the amount of the inventory fire loss. The supporting schedule of the computation of the gross profit margin should be in good form.

b. Assume that the amount of inventory fire loss computed in part "a" is $48,000 and that the actual cash value of the inventory at the date of the fire loss was $80,000. Prepare a schedule computing the pro rata claims to be filed with each insurance company for the inventory fire loss.

EXAMINATION IN ACCOUNTING PRACTICE—PART II

May 19, 1966; 1:30 to 6:00 p.m.

GROUP I

Solve all problems in this group.

Number 1 (Estimated time—30 to 40 minutes)

On August 25, 1965 Norton, Olson and Parker entered into a partnership agreement to acquire a speculative second mortgage on undeveloped real estate. They invested $55,500, $32,000 and $12,500, respectively. They agreed on a profit and loss ratio of 4:2:1, respectively.

On September 1, 1965 they purchased for $100,000 a mortgage note with an unpaid balance of $120,000. The amount paid included interest accrued from June 30, 1965. The note principal matures at the rate of $2,000 each quarter. Interest at the annual rate of 8% computed on the unpaid balance is also due quarterly.

Regular interest and principal payments were received on September 30 and December 31, 1965. A working capital imprest fund of $150 was established, and collection expenses of $70 were paid in December.

In addition to the regular September payment on September 30 the mortgagor made a lump-sum principal reduction payment of $10,000 plus a penalty of 2% for prepayment.

Because of the speculative nature of the note, the partners agree to defer recognition of the discount until their cost has been fully recovered.

Required:

a. Assuming that no cash distributions were made to the partners, prepare a schedule computing the cash balance available for distribution to the partners on December 31, 1965.

b. After payment of collection expenses the partners expect to have cash in the total amount of $170,000 available for distribution to themselves for interest and return of principal. They plan to distribute the cash as soon as possible so that they can individually reinvest the cash.

Prepare a schedule showing how the total cash of $170,000 should be distributed to the individual partners by installments as it becomes available.

Number 2 (Estimated time—50 to 60 minutes)

The president and principal stockholder of Liquidor Corporation died near the end of 1965. No buyer was found for his holdings so the decision was made with the approval of all stockholders to liquidate the Corporation under Section 337 of the Internal Revenue Code, which provides that gains or losses on sale of property during the period of a one-year liquidation are nontaxable. Property is defined as all assets other than stock-in-trade and installment obligations. (The gain on a bulk sale of stock-in-trade to one person, however, is nontaxable.)

A Plan of Liquidation was adopted as of January 1, 1966; it was anticipated that the affairs of the Corporation would be wound up by July 1, 1966, at which date all remaining assets would be distributed to the stockholders. A postclosing trial balance follows:

Liquidor Corporation

TRIAL BALANCE

December 31, 1965

	Debit	*Credit*
Cash	$ 82,900	
Accounts receivable	55,500	
Inventories	150,000	
Machinery and equipment	520,000	
Allowance for depreciation		$230,000
Prepaid insurance	3,600	
Treasury stock	25,000	
Accounts payable		89,500
Accrued liabilities		60,000
Federal income tax payable		10,000
Deferred income taxes		20,000
Capital stock, preferred		50,000
Capital stock, common		100,000
Capital contributed in excess of par value		60,000
Retained earnings		217,500
	$837,000	$837,000

The following information is available:

1. Inventories are stated at the lower of cost or market. The market value of the inventories is $180,000. The Company does not expect to make a bulk sale of the inventory.

2. A contract has been signed for the sale of the machinery and equipment on April 1, 1966 for $218,000.

3. The insurance coverage arising from the prepaid insurance premiums will extend beyond July 1, 1966; the premiums to be returned when the insurance is cancelled will amount to $800.

4. The balance in the Treasury Stock account is the cost of 1,000 shares of common stock purchased in 1962.

5. A total of 500 shares of $6 preferred stock, $100 par value, has been authorized and issued at par value. Dividends are cumulative and no dividends

were declared in 1965. The preferred stock is nonparticipating, callable at par value, and convertible into common stock at the rate of four common shares for each preferred share. All the preferred shareholders are expected to convert their shares into common stock.

6. The common stock has a par value of $5; 25,000 shares are authorized and 20,000 shares have been issued.

7. The Corporation has never had a net operating loss. Taxable incomes for recent years are as follows: 1961, $18,000; 1962, $21,000; 1963, $40,000; 1964, $45,000; 1965, $20,000. The income tax rate is 50%.

8. Contracts have been signed for the sale of research and development data (costing $250,000) for $300,000. These research and development expenditures have been expensed as incurred on the accounts of the Corporation but for tax purposes have been treated as capital expenditures and have not been amortized.

9. Cash expenses during the period of liquidation, January 1, 1966—July 1, 1966, are expected to be $55,000 and will consist principally of payroll, professional services, and other office expenses.

Required:

Starting with a calculation of stockholders' equity at December 31, 1965, prepare a schedule computing the estimated liquidating value per share of common stock on July 1, 1966. Assume that the estimated realizable values are correct and all liabilities will be settled at book value.

Number 3 (Estimated time—40 to 50 minutes)

Abner Akins is the proprietor of a retail business and has an investment portfolio. He has prepared the following analysis for use in preparing his 1965 income tax return:

Gross profit from business		$40,000
Operating expenses, including depreciation		12,000
Net operating income		28,000
Net loss on disposal of business assets		5,240
Net income from business		22,760
Net investment income		2,015
Net income before personal expenses		24,775
Personal expenses:		
Household expenditures	$7,300	
Life insurance premiums	700	
Contributions	6,500	
Automobile expense	900	
Drugs and medicine	400	
Other medical expenses	2,000	
Balance of 1964 Federal income taxes	185	
Payments on 1965 estimated Federal income taxes	1,500	
Real estate taxes	2,100	
Support payments to Mary Smith	2,200	23,785
Increase in net worth for the year		$ 990

The following information is available:

1. Abner Akins is 48 and his wife, Cora, is 46. They have a 23-year-old daughter, Joan, who had no income during the year and was married on December 1. She will file a joint return with her husband. Mr. Akins is the sole support of his mother-in-law, Mary Smith, 67, who maintains her own house.

2. An analysis of Net Loss on Disposal of Business Assets:

Cost of inventory lost in public warehouse fire on September 1		$(10,120)
(Inventory was uninsured Christmas merchandise carried over from prior year. Retail value was $15,600.)		
Gain on sale of future store site. (Purchased in 1959 for $5,500.)		4,000
Gain on trade-in of delivery truck on January 1		880
Invoice price of new truck and basis for recording straight-line depreciation based on 6-year life	$7,200	
Trade-in allowance for old truck	2,000	
Cash paid	$5,200	
(Old truck was purchased in 1961 and had a net book value of $1,120. Mr. Akins has agreed to take the additional first-year depreciation on the new truck for tax purposes.) (Disregard salvage values.)		
Net loss on disposal of business assets		$ (5,240)

3. An analysis of Net Investment Income:

General Motors Corporation dividends (stock owned jointly)	$1,090
Interest on savings accounts	75
Interest on State Turnpike Bonds	125
Total dividends and interest	1,290

Sales of securities:

	Acquired	*Date Sold*	*Basis*	*Sales Price*	*Gain*	
State Turnpike Bonds ...	3/1/63	10/1/65	$1,800	$2,100	$300	
Ito Corp. stock	5/9/65	10/8/65	3,600	4,200	600	
Net gain on sales of securities					900	
Less investment service subscription					175	725
Net investment income						$2,015

In 1964 Mr. Akins sold one security which resulted in a long-term capital loss of $2,750. Mr. and Mrs. Akins sold no other assets in 1964 and reported taxable income of $7,500 on a joint return for that year.

4. All contributions were made to St. Andrews Church and included a $5,000 payment to the church building fund.

5. An analysis of Drugs and Medicine and Other Medical Expenses:

Persons for Whom Expenditures Were Made	*Drugs and Medicine*	*Other Medical Expenses*
Mr. & Mrs. Akins	$ 30	$ 375
Joan Akins	120	525
Mary Smith	250	1,100
Total	$400	$2,000

6. The Automobile Expense of $900 was the cost of repairing the collision damage to the Akins' car caused by the faulty driving of Joan Akins.

7. The real estate taxes paid were $1,775 for the Akins' house and $325 for Mary Smith's house.

8. Mary Smith broke her hip in September and was subsequently confined to a nursing home where she could receive the benefit of intensive nursing care during her recovery. The support payments made to her included checks totaling $1,300 which she endorsed over to the nursing home in payment of fees.

Required:

Prepare a schedule computing the amount of total taxes payable for Abner and Cora Akins for 1965. Supporting schedules including those for depreciation and capital gains should be in good form. (Assume that the applicable income tax rate is 25% and that the self-employment tax rate is 5.4%.)

Number 4 (Estimated time—50 to 60 minutes)

The president of Small Corporation has requested your assistance in reconstructing a summary of factory operations during April for a job order cost system that has been maintained inadequately since his bookkeeper left for another position early in the month.

The Corporation's cost system includes a general ledger and a factory production ledger with reciprocal control accounts. A trial balance of the factory production ledger at April 1, 1966 showed the following:

	Debits	*Credits*
Raw materials	$30,000	
Store supplies inventory	10,000	
Work in process	20,000	
General ledger control		$60,000
	$60,000	$60,000

After reviewing the work done up to April 1, you gathered the following information for the month of April from the sources indicated on page 18.

				Work in Process				
					Service Depts.		Producing Depts.	
Sources of Information	General Ledger Control	Raw Materials	Store Supplies	Total	Power Plant	General Plant	Pattern Foundry	Machine Shop
From voucher register:								
Purchases	$(27,150)	$20,000	$ 7,150					
Direct labor	(6,150)			$6,150	$300	$ 350	$2,200	$3,300
Direct manufacturing expenses	(2,300)			2,300	50	175	730	1,345
Assets acquired	(9,400)							
Prepaid insurance	(3,000)							
From general ledger entries:								
Depreciation	(1,100)			1,100	140	80	*	*
Property taxes	(250)			250	40	20	*	*
Expired insurance	(500)			500	100	25	*	*
Repairs to power plant	(320)			320	320			
From requisitions:								
Raw materials		(27,000)		27,000	500	1,000	15,500	10,000
Store supplies	150		(15,150)	15,000	150	1,350	9,000	4,500
From cost of finished jobs report:								
Shipped to customers	45,000			(45,000)				
For company's own use	2,460			(2,460)				
Bases for distribution of costs:								
Power plant							50%	50%

General plant—store supplies issued to producing departments.
Indirect costs of producing departments—direct labor costs of each department.
*Balance to be distributed on basis of direct labor costs.
Debit/(credit).

Required:

Prepare a summary worksheet for the month ended April 30, 1966 to compute

1. Direct, indirect, and total costs that should be debited to Work-in-Process for the month.
2. The distribution of service department costs.
3. The April 30, 1966 balances of the following accounts in the factory production ledger:
   a. General Ledger Control
   b. Raw Materials
   c. Store Supplies
   d. Work-in-Process.

GROUP II

Estimated time—50 to 60 minutes.

Solve one of the two problems in this group. If both are solved, only the first will be considered.

Number 5

For many years you have prepared John Rich's income tax return on a cash basis and have provided him with tax-planning advice. He has recently inherited $100,000 which will be paid to him about January 1, 1967 when the estate is settled. He is considering the following investments for the $100,000:

1. Lease of a downtown parking lot which is the site of a proposed office building whose construction will begin in January 1977. He would be required to make an advance payment of $90,000 for the lease and to make monthly rental payments of $1,000. In addition he would spend $10,000 for the erection of a shelter which would be completed by the beginning of the lease period, January 1, 1967. The shelter would be depreciated by the straight-line method. Parking revenues are estimated to be $44,000 yearly and annual cash expenses, in addition to the rent, would amount to $8,500.

2. Purchase of an interest in a producing oil well on January 1, 1967 for $100,000. His share of the well's yearly income would be $20,000 less cash expenses of $8,250. The estimated value of his share of the well at the end of ten years is $65,000. The percentage depletion rate applicable to oil wells is 27½%.

The net cash flow after income taxes derived from these alternative investments would be invested at the end of each year in tax-exempt securities offering a 4% return paid in one annual payment at December 31. This annual payment would, in turn, be reinvested in the same kinds of tax-exempt securities. Tables for compounding interest at the rate of 4% are shown on page 20.

Periods	*Amount of 1*	*Amount of an Ordinary Annuity of 1*
1	1.040	1.000
2	1.082	2.040
3	1.125	3.122
4	1.170	4.246
5	1.217	5.416
6	1.265	6.633
7	1.316	7.898
8	1.369	9.214
9	1.423	10.583
10	1.480	12.006

Taxable income derived from the investment of the $100,000 would be subject to a tax rate of 60%. Long-term capital gains would be taxed at a rate of 25%.

Required:

Prepare schedules computing for a ten-year period the total cash flow after income taxes for each alternative investment, the parking lot and the oil well, including the cash flow derived from the reinvestment of available funds in the described tax-exempt securities. Total cash flow is the amount of cash accumulated over the ten-year period.

Number 6

The accounts of the City of Daltonville were kept by an inexperienced bookkeeper during the year ended December 31, 1965. The following trial balance of the General Fund was available when you began your examination:

City of Daltonville

GENERAL FUND TRIAL BALANCE

December 31, 1965

	Debit	*Credit*
Cash	$ 75,600	
Taxes receivable—current year	29,000	
Estimated losses—current year taxes receivable		$ 9,000
Taxes receivable—prior year	4,000	
Estimated losses—prior year taxes receivable		5,100
Appropriations		174,000
Estimated revenues	180,000	
Building addition constructed	25,000	
Serial bonds paid	8,000	
Expenditures	140,000	
Special assessment bonds payable		50,000
Revenues		177,000
Accounts payable		13,000
Unappropriated surplus		33,500
	$461,600	$461,600

Your examination disclosed the following:

1. The estimate of losses of $9,000 for current year taxes receivable was found to be a reasonable estimate.

2. The Building Addition Constructed account balance is the cost of an addition to the municipal building. The addition was constructed during 1965 and payment was made from the General Fund as authorized.

3. The Serial Bonds Paid account reports the annual retirement of general obligation bonds issued to finance the construction of the municipal building. Interest payments of $3,800 for this bond issue are included in Expenditures.

4. A physical count of the current operating supplies at December 31, 1965 revealed an inventory of $6,500. The decision was made to record the inventory in the accounts; expenditures are to be recorded on the basis of usage rather than purchases.

5. Operating supplies ordered in 1964 and chargeable to 1964 appropriations were received, recorded and consumed in January 1965. The outstanding purchase orders for these supplies, which were not recorded in the accounts at year end, amounted to $4,400. The vendors' invoices for these supplies totaled $4,700. Appropriations lapse one year after the end of the fiscal year for which they are made.

6. Outstanding purchase orders at December 31, 1965 for operating supplies totaled $5,300. These purchase orders were not recorded on the books.

7. The special assessment bonds were sold in December 1965 to finance a street paving project. No contracts have been signed for this project and no expenditures have been made.

8. The balance in the Revenues account includes credits for $10,000 for a note issued to a bank to obtain cash in anticipation of tax collections to pay current expenses and for $900 for the sale of scrap iron from the City's water plant. The note was still outstanding at year end. The operations of the water plant are accounted for by a separate fund.

Required:

a. Prepare the formal adjusting and closing journal entries for the General Fund.

b. The foregoing information disclosed by your examination was recorded only in the General Fund even though other funds or groups of accounts were involved. Prepare the formal adjusting journal entries for any other funds or groups of accounts involved.

EXAMINATION IN AUDITING

May 19, 1966; 8:30 a.m. to 12:00 m.

GROUP I

Answer all questions in this group.

Number 1 (Estimated time—25 to 30 minutes)

You are in charge of your second yearly examination of the financial statements of Hillsboro Equipment Corporation, a distributor of construction equipment. Hillsboro's equipment sales are either outright cash sales or a combination of a substantial cash payment and one or two 60- or 90-day nonrenewable interest-bearing notes for the balance. Title to the equipment passes to the customer when the initial cash payment is made. The notes, some of which are secured by the customer, are dated when the cash payment is made (the day the equipment is delivered). If the customer prefers to purchase the equipment under an installment payment plan, Hillsboro arranges for the customer to obtain such financing from a local bank.

You begin your field work to examine the December 31 financial statements on January 5 knowing that you must leave temporarily for another engagement on January 7 after outlining the audit program for your assistant. Before leaving, you inquire about the assistant's progress in his examination of notes receivable. Among other things, he shows you a working paper listing the makers' names, the due dates, the interest rates, and amounts of seventeen outstanding notes receivable totaling $100,000. The working paper contains the following notations:

1. Reviewed system of internal control and found it to be satisfactory.
2. Total of $100,000 agrees with general ledger control account.
3. Traced listing of notes to sales journal.

The assistant also informs you that he is preparing to request positive confirmation of the amounts of all outstanding notes receivable and that no other audit work has been performed in the examination of notes receivable and interest arising from equipment sales. There were no outstanding accounts receivable for equipment sales at the end of the year.

Required:

a. List the additional audit procedures that the assistant should apply in his audit of the account for notes receivable arising from equipment sales (Hillsboro has no other notes). No subsidiary ledger is maintained.

b. You ask your assistant to examine all notes receivable on hand before you leave. He returns in thirty minutes from the office safe where the notes are kept and reports that 1965 notes on hand total only $75,000.

List the possible explanations that you would expect from the client for the $25,000 difference. (Eliminate fraud or misappropriation from your consideration.) Indicate beside each explanation the audit procedures you would apply to determine if each explanation is correct.

Number 2 (Estimated time—25 to 30 minutes)

As a result of highly profitable operations over a number of years, Eastern Manufacturing Corporation accumulated a substantial investment portfolio. In his examination of the financial statements for the year ended December 31, 1965 the following information came to the attention of the Corporation's CPA:

1. The manufacturing operations of the Corporation resulted in an operating loss for the year.
2. In 1965 the Corporation placed the securities making up the investment portfolio with a financial institution which will serve as custodian of the securities. Formerly the securities were kept in the Corporation's safe deposit box in the local bank.
3. On December 22, 1965 the Corporation sold and then repurchased on the same day a number of securities that had appreciated greatly in value. Management stated that the purpose of the sale and repurchases was to establish a higher cost and book value for the securities and to avoid the reporting of a loss for the year.

Required:

a. List the objectives of the CPA's examination of the Investment account.

b. Under what conditions would the CPA accept a confirmation of the securities on hand from the custodian in lieu of inspecting and counting the securities himself?

c. What disclosure, if any, of the sale and repurchase of the securities would the CPA recommend for the financial statements? If the client accepts the CPA's recommendations for disclosure, what effect, if any, would the sale and repurchase have upon the CPA's opinion on the financial statements? *Discuss.*

Number 3 (Estimated time—20 to 25 minutes)

In connection with your examination of the financial statements of Olars Mfg. Corporation for the year ended December 31, 1965, your post-balance-sheet-date review disclosed the following items:

1. January 3, 1966: The state government approved a plan for the construc-

tion of an express highway. The plan will result in the appropriation of a portion of the land area owned by Olars Mfg. Corporation. Construction will begin in late 1966. No estimate of the condemnation award is available.

2. January 4, 1966: The funds for a $25,000 loan to the Corporation made by Mr. Olars on July 15, 1965 were obtained by him by a loan on his personal life insurance policy. The loan was recorded in the account Loan from Officers. Mr. Olars' source of the funds was not disclosed in the Company records. The Corporation pays the premiums on the life insurance policy and Mrs. Olars, wife of the president, is the beneficiary of the policy.

3. January 7, 1966: The mineral content of a shipment of ore en route on December 31, 1965 was determined to be 72%. The shipment was recorded at year end at an estimated content of 50% by a debit to Raw Material Inventory and a credit to Accounts Payable in the amount of $20,600. The final liability to the vendor is based on the actual mineral content of the shipment.

4. January 15, 1966: Culminating a series of personal disagreements between Mr. Olars, the president, and his brother-in-law, the treasurer, the latter resigned, effective immediately, under an agreement whereby the Corporation would purchase his 10% stock ownership at book value as of December 31, 1965. Payment is to be made in two equal amounts in cash on April 1 and October 1, 1966. In December the treasurer had obtained a divorce from his wife who was Mr. Olars' sister.

5. January 31, 1966: As a result of reduced sales, production was curtailed in mid-January and some workers were laid off. On February 5, 1966 all the remaining workers went on strike. To date the strike is unsettled.

6. February 10, 1966: A contract was signed whereby Mammoth Enterprises purchased from Olars Mfg. Corporation all of the latter's fixed assets (including rights to receive the proceeds of any property condemnation), inventories, and the right to conduct business under the name "Olars Mfg. Division." The effective date of the transfer will be March 1, 1966. The sale price was $500,000 subject to adjustment following the taking of a physical inventory. Important factors contributing to the decision to enter into the contract were the policy of the board of directors of Mammoth Industries to diversify the firm's activities and the report of a survey conducted by an independent market appraisal firm which revealed a declining market for Olars products.

Required:

Assume that the above items came to your attention prior to completion of your audit work on February 15, 1966 and that you will render a short-form report. For *each* of the above items:

(1) Give the audit procedures, if any, that would have brought the item to your attention. Indicate other sources of information that may have revealed the item.

(2) Discuss the disclosure that you would recommend for the item, listing all details that you would suggest should be disclosed. Indicate those items or details, if any, that should not be disclosed. Give your reasons for recommending or not recommending disclosure of the items or details.

Number 4 (Estimated time—25 to 30 minutes)

An important procedure in the CPA's audit programs is his review of the client's system of internal control.

Required:

a. Distinguish between accounting controls and administrative controls in a properly coordinated system of internal control.

b. List the essential features of a sound system of accounting control.

c. Explain why the CPA is concerned about the separation of responsibilities for operating custodianship, financial custodianship, and controllership.

Number 5 (Estimated time—25 to 30 minutes)

Terra Land Development Corporation is a closely held family corporation engaged in the business of purchasing large tracts of land, subdividing the tracts, and installing paved streets, and utilities. The Corporation does not construct buildings for the buyers of the land and does not have any affiliated construction companies. Undeveloped land is usually leased for farming until the Corporation is ready to begin developing it.

The Corporation finances its land acquisitions by mortgages; the mortgagees require audited financial statements. This is your first audit of the Company and you have now begun the examination of the financial statements for the year ended December 31, 1965.

Your preliminary review of the accounts has indicated that the Corporation would have had a highly profitable year except that the president and vice president, his son, were reimbursed for exceptionally large travel and entertainment expenses.

Required:

a. The Corporation has three tracts of land in various stages of development. List the audit procedures to be employed in the verification of the physical existence and title to the Corporation's three landholdings.

b. The president of the Corporation has asked you if you will prepare a report that will contain only the balance sheet. Before you can reply, he adds that he will remove the income statement from your report before submitting it to the mortgagees if you refuse to prepare a report containing only the balance sheet.

1. Would generally accepted auditing standards permit the preparation of an auditor's report containing only a balance sheet? *Discuss.*
2. What would be your response to the president's threat to remove the in-income statement from your auditor's report? *Discuss.*

Number 6 (Estimated time—25 to 30 minutes)

Renken Company cans two food commodities which it stores at various warehouses. The Company employs a perpetual inventory accounting system under which the finished goods inventory is charged with production and credited for sales at standard cost. The detail of the finished goods inventory is maintained on punched cards by the Tabulating Department in units and dollars for the various warehouses.

Company procedures call for the Accounting Department to receive copies of daily production reports and sales invoices. Units are then extended at standard cost and a summary of the day's activity is posted to the Finished Goods Inventory general ledger control account. Next the sales invoices and production reports are sent to the Tabulating Department for processing. Every month the control account and detailed tab records are reconciled and adjustments recorded. The last reconciliation and adjustments were made at November 30, 1965.

Your CPA firm observed the taking of the physical inventory at all locations on December 31, 1965. The inventory count began at 4:00 p.m. and was completed at 8:00 p.m. The Company's figure for the physical inventory is $331,400. The general ledger control account balance at December 31 was $373,900 and the final "tab" run of the inventory punched cards showed a total of $392,300.

Unit cost data for the Company's two products are as follows:

Product	*Standard Cost*
A	$2.00
B	3.00

A review of December transactions disclosed the following:

1. Sales invoice #1301, 12/2/65, was priced at standard cost for $11,700 but was listed on the Accounting Department's daily summary at $11,200.

2. A production report for $23,900, 12/15/65, was processed twice in error by the Tabulating Department.

3. Sales invoice #1423, 12/9/65, for 1,200 units of product A, was priced at a standard cost of $1.50 per unit by the Accounting Department. The Tabulating Department noticed and corrected the error but did not notify the Accounting Department of the error.

4. A shipment of 3,400 units of product A was invoiced by the Billing Department as 3,000 units on sales invoice #1504, 12/27/65. The error was discovered by your review of transactions.

5. On December 27 the Memphis warehouse notified the Tabulating Department to remove 2,200 unsalable units of product A from the finished goods inventory, which it did without receiving a special invoice from the Accounting Department. The Accounting Department received a copy of the Memphis warehouse notification on December 29 and made up a special invoice which was processed in the normal manner. The units were not included in the physical inventory.

6. A production report for the production on January 3 of 2,500 units of product B was processed for the Omaha plant as of December 31.

7. A shipment of 300 units of product B was made from the Portland warehouse to Ken's Markets, Inc. at 8:30 p.m. on December 31 as an emergency service. The sales invoice was processed as of December 31. The client prefers to treat the transaction as a sale in 1965.

8. The working papers of the auditor observing the physical count at the Chi-

cago warehouse revealed that 700 units of product B were omitted from the client's physical count. The client concurred that the units were omitted in error.

9. A sales invoice for 600 units of product A shipped from the Newark warehouse was mislaid and was not processed until January 5. The units involved were shipped on December 30.

10. The physical inventory of the St. Louis warehouse excluded 350 units of product A that were marked "reserved." Upon investigation it was ascertained that this merchandise was being stored as a convenience for Steve's Markets, Inc., a customer. This merchandise, which has not been recorded as a sale, is billed as it is shipped.

11. A shipment of 10,000 units of product B was made on December 27 from the Newark warehouse to the Chicago warehouse. The shipment arrived on January 6 but had been excluded from the physical inventories.

Required:

Prepare a worksheet to reconcile the balances for the physical inventory, Finished Goods Inventory general ledger control account, and Tabulating Department's detail of finished goods inventory ("Tab Run").

The following format is suggested for the worksheet.

	Physical Inventory	*General Ledger Control Account*	*Tabulating Department's Detail of Inventory*
Balance per client............	$331,400	$373,900	$392,300

GROUP II

Estimated time—30 to 35 minutes.

Answer one of the two questions in this group. If both are answered, only the first will be considered.

Number 7

Your examination of the financial statements of General Department Store, Inc. disclosed the following:

1. The Store has 30,000 retail accounts which are billed monthly on a cycle basis. There are 20 billing cycle divisions of the subsidiary accounts receivable ledger, and accounts are apportioned alphabetically to the divisions.

2. All charge sales tickets, which are prenumbered, are microfilmed in batches for each day's sales. These sales tickets are then sorted into their respective cycle divisions, and adding machine tapes are prepared to arrive at the total daily sales for each division. The daily totals for the divisions are then combined for comparison with the grand daily total charge sales determined from cash register read-

ings. After the totals are balanced, the daily sales tickets are filed behind the related customer account cards in the respective cycle divisions.

3. Cycle control accounts for each division are maintained by postings of the tapes of daily sales.

4. At the cycle billing date the customers' transactions (sales, remittances, returns and other adjustments) are posted to the accounts in the individual cycle. The billing machine used automatically accumulates six separate totals: previous balances, purchases, payments, returns, new balances, and overdue balances. After posting, the documents and the customers' statements are microfilmed and then mailed to the customer.

5. Within each division a trial balance of the accounts in the cycle, obtained as a by-product of the posting operation, is compared with the cycle control account.

6. Credit terms for regular accounts require payment within 10 days of receipt of the statement. A credit limit of $300 is set for all accounts.

7. Before the statements are mailed they are reviewed to determine which are past due. Accounts are considered past due if the full balance of the prior month has not been paid. Past due accounts are noted for subsequent collection effort by the credit department.

8. Receipts on account and customer account adjustments are accumulated and posted in a similar manner.

Required:

a. List the audit procedures that you would apply in the audit of the accounts comprising one billing cycle division. Confine your audit procedures to the sales tickets and charges to the accounts and to the verification of account balances. Do not discuss the audit of cash receipts or customer account adjustments.

b. Assume that the group of accounts selected for audit in part "a" was in the cycle division billed on January 19. List the additional over-all audit procedures that you would apply to satisfy yourself as to the reasonableness of the total balance of accounts receivable at January 31, 1966, the fiscal year end.

Number 8

CPAs may audit "around" or "through" computers in the examination of the financial statements of clients who utilize computers to process accounting data.

Required:

a. Describe the auditing approach referred to as auditing "around" the computer.

b. Under what conditions does the CPA decide to audit "through" the computer instead of "around" the computer?

c. In auditing "through" the computer, the CPA may use a "test deck."

1. What is a "test deck"?
2. Why does the CPA use a "test deck"?

d. How can the CPA satisfy himself that the computer program tapes presented to him are actually being used by the client to process its accounting data?

EXAMINATION IN COMMERCIAL LAW

May 20, 1966; 8:30 a.m. to 12 m.

All questions are required.

Number 1 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered statements states a legal conclusion. You are to determine whether *each* legal conclusion is true or false according to *general principles of corporation law*. Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

An example of the manner in which the questions should be marked is shown in the following illustration:

Question

XX The following elements are necessary to constitute a pledge:

1. Possession by the pledgor.
2. Property used to secure a loan or other obligation.
3. Either real or personal property.
4. A right of redemption retained by the pledgor.
5. Title retained by the pledgor.

Answer Sheet

1. False
2. True
3. False
4. True
5. True

Questions to be Answered

A. If the existence of a corporation is challenged, a corporation would be found to exist

1. If it is a *de jure* corporation.
2. Even though all of the corporation's stock is owned by one individual.
3. Even though the corporation is engaging in acts which are beyond the scope of the activities authorized by its charter.
4. Even though A, B and C, doing business as partners, decided to consider themselves bound as a corporation and do business using a corporate name.
5. Even though the term of corporate existence specified in the charter has long expired, but the corporation continues to carry on its activities using the corporate name.

B. If a corporation has been organized by promoters,

6. It cannot be a closed corporation.
7. The promoters were the agents of the corporation prior to its formation.
8. The corporation can sue on a contract made by a promoter which it has adopted.
9. Before the corporation was formed the rules of joint venture governed the promoters' relationships among themselves.
10. And if creditors are defrauded by promoters, the creditors' sole recourse would be against the corporation.

C. If a corporation does a substantial amount of business in a state in which it is not incorporated,

11. It must incorporate in that state in order to enjoy the benefit of its laws.
12. It may be required to qualify in that state in order to do intrastate business within that state.
13. It may always incorporate under a federal incorporation law and thereby be permitted to do business in any number of states.
14. It may be sued in that state for acts which are carried out in that state.
15. It cannot be taxed by that state.

D. Directors of a corporation

16. Are elected by the officers of the corporation.
17. May declare a stock dividend.
18. Are agents of the shareholders.
19. May fix executive compensation.
20. May exercise their powers individually.

E. Officers of a corporation

21. Are elected by the shareholders.
22. May be removed by the board of directors.
23. Have no implied authority arising out of their offices.
24. May be liable on contracts they enter into if they do not indicate that they are contracting as agents for a corporation.
25. May not also be directors of the corporation.

F. If an officer of a corporation does outstanding work for the corporation, he may be rewarded for his special services by receiving
   26. A stock bonus.
   27. Deferred compensation.
   28. The right to purchase property which the corporation ultimately wishes to acquire.
   29. The right to purchase corporate assets at a nominal price.
   30. The right to an unlimited expense account.

G. A shareholder's proxy
   31. May be solicited by persons who are not officers of the corporation.
   32. May be irrevocable in some cases.
   33. Is always revocable.
   34. May not be sold.
   35. May be given for a forthcoming election by a shareholder who has sold his stock "ex-voting" rights.

H. The shareholders of a closed corporation may agree among themselves
   36. Completely to prohibit the sale of corporate stock.
   37. To prohibit the sale of corporate stock prior to the stock being offered to the original shareholders at a specified price.
   38. To fix a price for the purchase of a deceased shareholder's stock by the corporation.
   39. To place their shares in a voting trust.
   40. To have the corporation carry life insurance on the life of each shareholder.

I. The right to cumulative voting
   41. Applies only to the election of directors.
   42. Is diluted by increasing the number of vacancies to be filled.
   43. Might be eliminated by amendment if it merely exists pursuant to a provision of the bylaws and is not required by statute.
   44. Helps insure majority control.
   45. Is mandatory in some jurisdictions.

J. A derivative suit
   46. Can be brought by directors or officers of the corporation.
   47. Can be brought by shareholders of the corporation.
   48. Is sometimes referred to as a "representative" or "class" suit.
   49. Can be brought to compel the corporation to allow a shareholder to inspect corporate books and records.
   50. If successful, does not generally result in a direct recovery to the person bringing suit.

K. A shareholder's common law right of inspection
   51. Permits inspection of corporate books for any purpose.
   52. Permits inspection of corporate books at any place or time.
   53. Would permit inspection of the corporation's physical plant.

54. May permit inspection of the minutes of directors' meetings.
55. Would permit the shareholder to have the assistance of his accountant in carrying on an inspection.

L. Dissolution of a corporation
56. Is not synonymous with the liquidation of a corporation.
57. Must be under court supervision.
58. Once begun, cannot be prevented even if found to be oppressive to a particular group.
59. Automatically terminates the corporation's existence for all purposes.
60. Terminates the corporation's right to sue.

Number 2 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether *each* of the legal conclusions is true or false according to the *general principles of contract law*. Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. The following promises are sufficiently definite to create a contract:
61. A promises B to sell to B, and B promises A to buy from A, all goods of a certain character and price which B shall need in his business during the ensuing year.
62. A promises B to sell to him and B promises A to buy from A goods "at cost plus a nice profit."
63. A and B promise that specified performances shall be mutually rendered by them "in about nine months time."
64. A promises B to employ him for a stated compensation, and B promises A to serve as long as B is able to do the work or as long as business is carried on.
65. A promises B to do a specified job and B promises A to pay a specified amount therefor if performance is satisfactory to B.

B. In an auction
66. The auctioneer invites offers.
67. The auctioneer invites acceptances.
68. That is announced to be without reserve, the auctioneer cannot withdraw the item to be auctioned under any circumstances.
69. That is announced to be without reserve, a bidder cannot withdraw his bid once it has been made.
70. Any bidder can withdraw his bid before a sale is completed.

C. If an offer of a reward is made for information leading to the capture of a criminal, the reward may be collected by

71. A, a policeman who knew of the reward and arrested the criminal in the line of duty.
72. B, a citizen who knew of the reward and gave information leading to the arrest of the criminal but did not participate in the arrest.
73. C, a citizen who captured the criminal without knowledge of the reward.
74. D and E jointly, if they knew of the reward and their information and acts, taken together, caused the capture of the criminal.
75. The criminal who surrendered to a policeman.

D. If all communications are properly addressed and stamped and sent through the mails and the offeror has not specified the means of acceptance, a contract exists where

76. An acceptance is sent and lost.
77. The offeree sends a rejection, and then an acceptance, and then the offeror receives the rejection, and then the acceptance.
78. The offeree sends an acceptance and then a rejection, and the offeror receives the rejection, and then the acceptance.
79. The offeree sends a rejection, and then an acceptance, and the offeror receives the acceptance, and then the rejection.
80. The offeree sends an acceptance, and then a rejection, and the acceptance is lost and the offeror receives the rejection.

E. The doctrine of consideration

81. Has been totally abolished in several jurisdictions.
82. Has been abolished in all jurisdictions recognizing the doctrine of promissory estoppel.
83. Has been eliminated, in part, by statute in several jurisdictions.
84. Is a common law doctrine.
85. May consist of an act, a forbearance, or a return promise.

F. Under the Statute of Frauds, a writing will be required to evidence

86. An offer to sell land.
87. An acceptance of an offer to sell land.
88. An agreement made in consideration of marriage.
89. A promise by an executor to use estate funds to pay a decedent's debts.
90. A promise made to a debtor to be responsible for his debt.

G. The parol evidence rule

91. Applies only to an integrated contract.
92. Affects the admissibility as evidence of subsequent oral statements which contradict an earlier written contract.
93. Affects the admissibility as evidence of oral statements made at the time the contract was signed, which explain the terms of a writing.
94. Affects the admissibility as evidence of an oral statement made prior to the date of the contract, which conditioned the existence of the contract.

95. Affects the admissibility as evidence of a writing which contradicts the terms of a subsequent integrated contract.

H. If an agreement is illegal and both parties were aware of the fact when they entered into the agreement,

96. Neither party may sue the other for damages for breach of contract.
97. Either party may sue the other for return of any consideration tendered.
98. Either party may sue the other for the benefit he bestowed on him.
99. Either party may sue the other for the value of his services.
100. The contract is void as to both parties.

I. A third party beneficiary contract

101. Requires that three persons enter into a contract together.
102. Is enforceable by a donee beneficiary.
103. Is enforceable by a creditor beneficiary.
104. Is enforceable by an incidental beneficiary.
105. Is enforceable by the promisee.

J. The doctrine of substantial performance

106. Has most frequently been applied in cases of building contracts.
107. If applied, will require payment of the full contract price.
108. May be applied even though there has been an express waiver of any defect.
109. May be applied if the obligor intentionally departed from the contract in a minor detail.
110. May be applied even though the obligor unintentionally departed from the contract in a minor detail if the cost of replacement would be grossly and unfairly out of proportion to the good to be accomplished by complete performance.

K. An anticipatory breach of contract

111. May involve the breach of an express term of a contract.
112. May involve the breach of an implied term of a contract.
113. Does not give the innocent party a right to elect to wait until the time for performance to sue for breach of contract.
114. Of an employment contract always allows the prospective employee to collect full damages even if at the time of suit he has a better job at higher pay.
115. Occurs if there is a present inability to perform, even if there is a willingness and capability to perform at the future time called for by the contract.

L. In assessing contract damages, a court will usually grant a plaintiff

116. Compensatory damages.
117. Foreseeable damages.
118. Punitive damages.
119. Damages stipulated in a liquidated damage clause.
120. Specific performance whenever plaintiff prefers such recovery to a money judgment.

Number 3 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether *each* of the legal conclusions is true or false according to the *general principles of trust, estate and real property law*. Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. X may effectively dispose of his interest in the following property by will:
- 121. Property he owns as a joint tenant.
- 122. Property he owns as a tenant by the entirety.
- 123. Property he owns as a tenant in common.
- 124. Insurance proceeds payable to his estate.
- 125. X's life estate in real property.

B. X may effectively
- 126. Make a contract to make a particular provision in his will.
- 127. Make a holographic will with his wife.
- 128. Orally revoke his will.
- 129. Execute a new will which does not revoke a prior will.
- 130. Amend a prior will by executing an unwitnessed codicil.

C. In his will X may not effectively
- 131. Revoke his prior will if he does not have capacity to execute a new will.
- 132. Revive an old will after it has been revoked.
- 133. Designate a particular fund in his will from which transfer and estate taxes are to be paid.
- 134. Appoint a guardian for his minor children.
- 135. Establish a trust to run as long as any of his descendants are living.

D. X may effectively condition a bequest made in his will by requiring the legatee
- 136. To survive X for six months.
- 137. To attend X's funeral service.
- 138. To refrain from attacking X's will.
- 139. To commit a crime.
- 140. To be under the age of twenty-one at X's death.

E. After X's death, the executor named in X's will
- 141. Must, under all circumstances, offer the will for probate.
- 142. May refuse to serve because he is too busy.
- 143. Will receive letters of administration to evidence his appointment.
- 144. Must offer X's will for probate in the state in which the will was drawn.
- 145. Will be required to post a bond if the will does not relieve him of this obligation.

F. After X's death, his personal representative will have the implied power
146. To pay X's funeral expenses and debts.
147. To erect a suitable gravestone on his grave.
148. To use estate funds to continue to maintain and expand X's business.
149. To use estate funds to invest in a new business.
150. To continue to administer the estate for as long a time as the majority of beneficiaries wish him to do so.

G. If during his lifetime X decides to establish a trust, he may
151. Provide that the income from the trust is to be paid to himself during his life and that on his death the principal of the trust is to be distributed to his estate.
152. Appoint himself as one of the trustees of the trust.
153. Reserve the right to revoke the trust.
154. Bequeath part of his estate to the trust by his will.
155. Provide that the income from the trust is to be paid to Y charity for five hundred years.

H. If during his life X establishes a trust, he may not authorize his trustee
156. To keep all trust assets invested in a particular stock.
157. To allocate stock dividends received to principal rather than to income.
158. To lend money to the trust.
159. To withhold income from one beneficiary and pay it to another.
160. To accumulate income for a minor.

I. If X establishes a trust, the provisions of the trust will not be effective to the extent that the trust
161. Encourages the furtherance of an unlawful purpose.
162. Is established to hold insurance policies on X's life.
163. Violates the rule against perpetuities.
164. Prohibits the beneficiary from assigning his income from the trust.
165. Stipulates the particular state law which is to govern the trust.

J. X now owns Blackacre. Ultimately he wants this land to belong to the Y charity.
166. X may presently give Blackacre to the Y charity and reserve to himself a life estate with a general power of appointment over the property.
167. If X makes an unrestricted outright gift of Blackacre to the Y charity, Y charity may then sell the property even if X does not approve of the sale.
168. In his will, X may devise Blackacre to the Y charity but provide that the property will revert to his estate if it is not used for educational purposes.
169. In his will, X may not effectively devise Blackacre to his wife for life if she survives him, then to the Y charity.
170. If Y charity is no longer in existence at the time it is to receive Blackacre, the *cy-pres* doctrine may be applied.

K. If X decides to give Blackacre to the Y charity during his life, and if the charity agrees to accept the property, X may effectively transfer title
171. Even though he lacks capacity to contract.

172. By delivering a quit claim deed.
173. By sending a letter clearly manifesting his intent to make a present gift of the property to the Y charity.
174. And reserve to himself an easement allowing him to hunt on the property.
175. And require the Y charity to maintain the property and pay all expenses in connection with its upkeep.

L. If X makes a completed unrestricted gift of Blackacre to Y charity, Y charity
176. May find its title is subject to a dower claim by X's wife.
177. May abandon its title to the property.
178. May be required to give up the property to the state if the state exercises its power of eminent domain for a private purpose.
179. May sue X, the former owner of the property, for wasting the property during the time he held it.
180. May force X, the former owner of the property, to retake the property if it is found to be unsuitable for Y charity's purposes.

Number 4 (Estimated time—20 to 25 minutes)

Paul was hired as a file clerk by the Cattleman's Bank. As it did for all employees, the Bank paid a bonding company to furnish a bond indemnifying the Bank against loss arising from Paul's performance of his clerical duties. After six months with the Bank, Paul was promoted to a teller's position. Within one month after he became a teller the Bank learned that Paul had embezzled $25,000.

Required:

a. Describe the meaning of the term "suretyship" relationship.
b. Describe the relationship between
 1. Paul and the Bank,
 2. The Bank and the bonding company, and
 3. Paul and the bonding company.

c. On what grounds, if any, may the bonding company refuse to indemnify the Bank? *Explain.*

d. If the bonding company indemnifies the Bank on what theory, or theories, may the bonding company proceed to recover against Paul? *Explain.*

Number 5 (Estimated time—20 to 25 minutes)

Price and James, a New York accounting firm, was engaged by East Coast Builders to perform an annual audit. East Coast is a wholly owned subsidiary of Nationwide Builders, a national building company with headquarters in Los Angeles, California. The agreement signed by East Coast and Price and James for the audit was prepared by counsel for Nationwide. Except for the insertion of names, the fee and the service to be performed, it was the standard agreement for accounting services used by Nationwide.

The agreement has five pages and the clauses contained therein are written in small type. On page 4, the agreement provides:

"This agreement incorporates by reference all the Rules and Regulations of Nationwide's Hiring and Procurement Department which are on file and available for inspection at Nationwide's home office in Los Angeles, California."

Price and James signed the agreement and proceeded to perform the audit. A dispute regarding fees has now arisen. East Coast has informed Price and James that the Rules and Regulations incorporated into the agreement provide for the final settlement of any disputes by arbitration in Los Angeles before a panel of arbitrators selected by the American Building Association, an organization of builders.

Required:

a. Are the parties to a contract free to incorporate an arbitration clause into their contract by reference? *Explain.*

b. If Price and James never read the Rules and Regulations incorporated into the contract, is it possible that it may be bound to arbitrate? *Explain.*

c. If Price and James attempts to set aside the arbitration requirement in court, *discuss* fully the arguments that it could assert and the opposing arguments that East Coast Builders could use for upholding its right to an arbitration.

d. Assuming the parties arbitrate and Price and James loses the arbitration, may it successfully appeal to a court to overturn the arbitrators' findings if it can prove that the findings were not made in good faith? *Explain.*

Number 6 (Estimated time—20 to 25 minutes)

A, B and C formed the ABC Company, a partnership, with A contributing $12,000 of capital, B contributing $8,000 and C contributing $6,000. In their partnership agreement, A, B and C provided that the partnership was to exist for twenty years, but the partners made no provision as to the proportions in which profits and losses were to be shared. During the course of operating the partnership, A made a loan of $1,000 to the partnership which has not been repaid and the partnership also owes outside creditors additional amounts which exceed the value of partnership assets by $3,000.

Required:

a. Under the Uniform Partnership Act, in absence of a specific agreement between the parties, how is the compensation and profit for each partner determined during the course of operating the partnership?

b. Under the Uniform Partnership Act

1. If A wishes to terminate the partnership but B and C do not, does A have the right to withdraw from the partnership? *Explain.*
2. If A, B and C agree to terminate the partnership, how will losses be divided?

c. Discuss

1. The rule of marshalling of assets.

2. The distinction between the "dissolution" of the partnership and the "winding up" of partnership affairs.

d. If D becomes a partner in ABC Company and replaces A, what is D's liability with respect to obligations arising before his admission to the partnership?

Number 7 (Estimated time—25 to 30 minutes)

Bill went to Ed's Motors and purchased a new automobile. Two weeks later, Bill was called by MNO Loan Company. The Company explained to Bill that it had been financing Ed's purchases of automobiles from the manufacturer and that to protect its interests it had obtained a perfected security interest in Ed's entire inventory of automobiles, including the car which Bill bought. MNO further explained that Ed had defaulted on a payment due to MNO and MNO intended to assert its security interest in Bill's car and repossess it unless Bill was willing to make an additional payment of $500 for a release of MNO's security interest.

Required:

a. If Bill refuses to make an additional payment, what rights, if any, can MNO Loan Company assert against the automobile? (Assume the Uniform Commercial Code is not in effect.) *Explain.*

b. Assume that the Uniform Commercial Code is in effect:
1. Discuss the scope of Article 9, which deals with secured transactions, of the Uniform Commercial Code. What prior laws governing secured transactions does this Article repeal?
2. Explain what is meant by the terms "security interest," "purchase money" security interest, and "perfected" security interest.

c. Assume that the Uniform Commercial Code is in effect:
1. What steps were necessary for MNO Loan Company to obtain a perfected security interest in Ed's inventory of automobiles?
2. Does your answer to part "a" of this question differ if the Uniform Commercial Code is in effect? *Explain.*

Number 8 (Estimated time—25 to 30 minutes)

Baker offered to lend Able $20,000 at 5% interest per annum if Able agreed to pledge 100 shares of his stock in XYZ Corporation to secure the loan.

At the closing of the loan, Able found that he only owned 75 shares of XYZ Corporation stock and could not pledge the agreed number of shares until the next day, when he would be able to purchase an additional 25 shares of stock. As a courtesy to Able, and in order to allow the closing to proceed, Charlie, who was present at the closing, suggested that he (Charlie) sign the note for the amount to be loaned as a co-maker with Able. An "understanding" was reached that as soon as Able purchased additional shares of stock and pledged them the note which Charlie signed would be destroyed and a new note, executed solely by Able, would replace it.

Upon reaching agreement on the above arrangement, Able delivered 75 shares of XYZ Corporation to Baker, and Able and Charlie executed as co-makers and delivered to Baker a negotiable promissory demand note for $20,000, with interest at 5%, payable to Baker's order. The note contained no mention of the parties' "understanding."

Able, Baker and Charlie also signed a separate agreement referring to the note and outlining the "understanding" the parties had come to with regard to the substitution of a new note, executed solely by Able, upon delivery of an additional 25 shares of XYZ stock to Baker as security. The agreement stated that Baker was not to transfer the first note.

Baker then delivered to Charlie his check in the amount of $20,000.

Immediately after the closing, Baker went to the local bank and discounted the note. At the bank's request, Baker indorsed the note by signing his name on the back. The next day Able purchased 25 shares of XYZ stock, heard of the transfer of the note to the bank, and tendered the shares to the bank. Able showed the separate agreement and asked to be allowed to substitute his note, executed solely by himself, in place of the note the bank held. The bank refused to allow the substitution. Shortly thereafter, Baker disappeared. His check has proved to be worthless.

Required:

a. List the requisites needed for an instrument to be negotiable.

b. 1. What is Charlie's relationship to Able? *Explain.*

2. What is Baker's relationship to the bank? *Explain.*

c. Is the bank a holder in due course of the note? *Explain.*

d. Did the bank have a right to refuse to allow Able to substitute a new note? *Explain.*

e. 1. What right, if any, does the bank have against Charlie? *Explain.*

2. If Charlie has to pay, what right does he have against Able? *Explain.*

EXAMINATION IN THEORY OF ACCOUNTS

May 20, 1966; 1:30 p.m. to 5 p.m.

All questions are required.

Number 1 (Estimated time—25 to 35 minutes)

Select the *best* answer choice for each of the following items and on a separate answer sheet write the letter of your answer choice.

An example of the manner in which the answer sheet should be marked is shown in the following illustration:

Question

XX The current asset section of the balance sheet should include
- a. Machinery.
- b. Cash.
- c. Goodwill.
- d. Taxes payable.

Answer Sheet

XX b.

Questions to be Answered

1. Consolidated financial statements are *not* appropriate if
   - a. The subsidiary is in legal reorganization.
   - b. The minority interest is small.
   - c. The subsidiary has a large bonded indebtedness to outsiders.
   - d. The parent buys nothing from the subsidiary.

2. Other things being equal, a profitable baking company that can sell sandwich bread, one of several products, for only 90% of its total cost (allocated overhead makes up 30% of its total cost) should
   - a. Buy extra equipment in order to increase output and thereby attempt to lower production costs per loaf.
   - b. Eliminate the sandwich bread.
   - c. Allocate its overhead by some other method.

d. Eliminate the sandwich bread only when its contribution to allocated overhead is reduced to zero.

3. A manufacturing company that inspects its units of product at the end of the production process will want to relieve work-in-process inventory of the cost of unavoidable spoilage and will, therefore, in the computation of equivalent production, weight the unavoidably spoiled units discovered at the inspection point by

a. Zero (thus ignoring the units).
b. One half.
c. One.
d. Two.

4. A plant site donated by a township to a manufacturer that plans to open a new factory should be recorded on the manufacturer's books at

a. The nominal cost of taking title to it.
b. Its market value.
c. One dollar (since the site cost nothing but should be included in the balance sheet).
d. The value assigned to it by the company's directors.

5. Gross (profit) margin variation analysis may be used to determine the amount of variation in the

a. Sales and cost of goods sold accounted for by changes in sales price and physical volume.
b. Operating expenses caused by a change in the physical sales volume.
c. Physical sales volume caused by a change in sales price.
d. Cost of goods sold accounted for by a change in sales price.

6. Income tax allocation procedures are *not* appropriate when

a. An extraordinary loss will cause the amount of income tax expense to be less than the tax on ordinary net income.
b. An extraordinary gain will cause the amount of income tax expense to be greater than the tax on ordinary net income.
c. Differences between net income for tax purposes and financial reporting occur because tax laws and financial accounting principles do not concur on the items to be recognized as revenue and expense.
d. Differences between net income for tax purposes and financial reporting occur because, even though financial accounting principles and tax laws concur on the items to be recognized as revenues and expenses, they do not concur on the timing of the recognition.

7. Other variables remaining constant, the return on investment in inventory of a merchandising company will increase with a decrease in

a. Sales.
b. Inventory turnover.
c. The profit margin.
d. The investment in inventory.

8. The "payback method" is appropriate for evaluating alternative proposals to buy equipment that has a useful life at least

a. As long as the payback period.
b. Twice as long as the payback period.
c. Three times as long as the payback period.
d. Four times as long as the payback period.

9. The date on which to measure the compensation element in a stock option granted to a corporate employee is the date on which the employee
a. Is granted the option.
b. Has performed all conditions precedent to exercising the option.
c. May first exercise the option.
d. Exercises the option.

10. Which of the following items is a current liability?
a. Bonds (for which there is an adequate sinking fund classified as a long-term investment) due in three months.
b. Bonds due in three years.
c. Bonds (for which there is an adequate equity reserve) due in eleven months.
d. Bonds to be refunded when due in eight months, there being no doubt about the marketability of the refunding issue.

11. The matching concept is *least* relevant to accounting for a
a. Manufacturing corporation with a three-month production cycle.
b. Manufacturing corporation with a fifteen-month production cycle.
c. Joint venture organized to subdivide and market lots in a large realty development.
d. Joint venture organized to market this year's apple crop from 500 acres of trees.

12. In the conversion of the trial balance of a foreign branch, increases in the translated value of foreign net current assets resulting from an upward fluctuation in the foreign exchange rate should be
a. Credited to current income.
b. Debited as a current expense of operations.
c. Offset against prior provisions for unrealized losses, the excess of the increase being credited to a suspense account.
d. Credited to retained earnings in order to state the income from operations fairly.

13. The starting point in preparing a comprehensive budget for a manufacturing company limited by its ability to produce and *not* by its ability to sell is
a. A sales forecast.
b. An estimate of productive capacity.
c. An estimate of cash receipts and disbursements.
d. A projection of fixed asset acquisitions.

14. Overhead in a factory with service departments that render many services to each other is *least* accurately reapportioned by
a. Simultaneous equations.

b. Matrix algebra.
c. The "direct" method of reapportioning each service department's total costs directly to the producing departments.
d. The "step" method of first reapportioning the costs of the department that renders the most service to other service departments, avoiding the recirculation of service costs of subsequent departments.

15. If the actual amount of materials used equals the standard amount of materials that should have been used, the difference between the standard cost and actual cost of materials is called the
a. Quantity variance.
b. Cost variance.
c. Rate variance.
d. Price variance.

16. The retail inventory method is based on the assumption that the
a. Final inventory and the total of goods available for sale contain the same proportion of high-cost- and low-cost-ratio goods.
b. Ratio of gross margin to sales is approximately the same each period.
c. Ratio of cost to retail changes at a constant rate.
d. Proportions of markups and markdowns to selling price are the same.

17. A noncancelable lease in which equity in the property accumulates should be regarded as a purchase when the
a. Property is acquired by the lessor for the needs of the lessee and other prospective lessees.
b. Lessee guarantees the obligations of the lessor for the property leased.
c. Term of the lease is less than the estimated useful life of the property, and the lessor pays taxes, insurance, and maintenance on the property.
d. Lessee treats the lease as a rental for tax purposes.

18. When an established company adopts a pension plan, the costs related to past services of employees should be charged to
a. Operations of current and future periods.
b. Operations of prior periods.
c. Operations of the current period.
d. Retained earnings.

19. The straight-line method of depreciation is *not* appropriate for
a. A company that is neither expanding nor contracting its investment in equipment because it is replacing equipment as the equipment depreciates.
b. Equipment on which maintenance and repairs increase substantially with age.
c. Equipment with useful lives that are not affected by the amount of use.
d. Equipment used consistently every period.

20. Depreciation on the general fixed assets of municipal government and similar public organizations is usually
a. Recorded on a straight-line basis.
b. Recorded on a replacement cost basis.

c. Recorded on an annuity basis.
d. Not recorded.

Number 2 (Estimated time—25 to 30 minutes)

The Tiger Corporation, a retail fuel oil distributor, has increased its annual sales volume to a level three times greater than the annual sales of a dealer it purchased in 1958 in order to begin operations.

The board of directors of Tiger Corporation recently received an offer to negotiate the sale of Tiger Corporation to a large competitor. As a result, the majority of the board wants to increase the stated value of goodwill on the balance sheet to reflect the larger sales volume developed through intensive promotion and the current market price of sales gallonage. However, a few of the board members would prefer to eliminate goodwill altogether from the balance sheet in order to prevent "possible misinterpretations." Goodwill was recorded properly in 1958.

Required:

a. 1. Discuss the meaning of the term "goodwill." Do *not* discuss goodwill arising from consolidated statements or the conditions under which goodwill is recorded.
 2. List the techniques used to calculate the tentative value of goodwill in negotiations to purchase a going concern.

b. Why are the book and market values of the goodwill of Tiger Corporation different?

c. Discuss the propriety of
 1. Increasing the stated value of goodwill prior to the negotiations.
 2. Eliminating goodwill completely from the balance sheet prior to negotiations.

Number 3 (Estimated time—25 to 30 minutes)

At the completion of the Darby Department Store audit, the president asks about the meaning of the phrase "in conformity with generally accepted accounting principles" that appears in your audit report on the management's financial statements. He observes that the meaning of the phrase must include more than what he thinks of as "principles."

Required:

a. Explain the meaning of the term "accounting principles" as used in the audit report. (Do *not* discuss in this part the significance of "generally accepted.")

b. The president wants to know how you determine whether or not an accounting principle is generally accepted. Discuss the sources of evidence for determining whether an accounting principle has substantial authoritative support. Do *not* merely list the titles of publications.

c. The president believes that diversity in accounting practice always will exist among independent entities despite continual improvements in comparability. Discuss the arguments that *support* his belief.

Number 4 (Estimated time—20 to 25 minutes)

The Overseas Trading Company, a U. S. corporation with several foreign subsidiaries, appended the following footnote to its December 31, 1965 financial statements:

> "Marketable securities" includes $15,100 of freely transferable import certificates issued by the government of a foreign country. The certificates entitle the bearer to import into the foreign country certain restricted luxury items (costing up to 40% of the invoice prices of the exports on which the certificates were issued) that cannot otherwise be imported. They were issued by the foreign government as an incentive to export goods from the foreign country and were valued at market on the dates received (current market, $15,250). Our foreign subsidiary does not import luxury items and expects to sell all certificates during the next operating period. The foreign government's policy is expected to continue indefinitely.

Required:

a. Discuss the propriety of valuing the certificates at market on the dates they are received.

b. Discuss the propriety of treating the credit arising from the receipt of the certificates as

1. A reduction of cost of goods sold.
2. An addition to stockholders' equity.
3. An addition to other or special income.
4. An addition to gross sales.

Number 5 (Estimated time—25 to 30 minutes)

The president of Taylor School Supply Company, a wholesaler, presents you with a comparison of distribution costs for two salesmen and wants to know if you think the salesmen's compensation plan is working to the detriment of the Company. He supplies you with the following data:

	Salesmen	
	McKinney	*Sim*
Gross sales	$247,000	$142,000
Sales returns	17,000	2,000
Cost of goods sold	180,000	85,000
Reimbursed expenses (e.g., entertainment)	5,500	2,100
Other direct charges (e.g., samples distributed)	4,000	450
Commission rate on gross sales dollars	5%	5%

Required:

a. A salesman's compensation plan encourages him to work to increase the measure of performance to which his compensation is related. List the questionable sales practices by a salesman that might be encouraged by basing commissions on gross sales.

b. 1. What evidence that the compensation plan may be working to the detriment of the Company can be found in the data?
   2. What other information should the president obtain before reaching definite conclusions about this particular situation? *Why?*

Number 6 (Estimated time—25 to 30 minutes)

The Unknown Corporation purchased $144,000 of equipment in 1965 for $90,000 cash and a promise to deliver an indeterminate number of treasury shares of its $5.00 par common stock, with a market value of $15,000 on January 1 of each year for the next four years. Hence $60,000 in "market value" of treasury shares will be required to discharge the $54,000 balance due on the equipment.

The Corporation then acquired 5,000 shares of its own stock in the expectation that the market value of the stock would increase substantially before the delivery dates.

Required:

a. Discuss the propriety of recording the equipment at
   1. $90,000 (the cash payment).
   2. $144,000 (the cash price of the equipment).
   3. $150,000 (the $90,000 cash payment + the $60,000 market value of treasury stock that must be transferred to the vendor in order to settle the obligation according to the terms of the agreement).

b. Discuss the arguments *for* treating the balance due as
   1. A liability.
   2. Treasury stock subscribed.

c. Assuming that legal requirements do not affect the decision, discuss the arguments *for* treating the Corporation's treasury shares as
   1. An asset awaiting ultimate disposition.
   2. A capital element awaiting ultimate disposition.

Number 7 (Estimated time—25 to 30 minutes)

The practice of obtaining the right to use property by noncancelable leases is becoming more prevalent.

Required:

a. Assets acquired under noncancelable leases that are in substance installment purchases should be capitalized in the accounts of the lessee in order to show the facts properly. List the defects in the lessee's balance sheet and income statement that would result from *not* recording assets acquired under such contracts.

b. Other noncancelable leases that give the lessee essentially all the rights and obligations of ownership are not installment purchases in substance.

1. Discuss the case *against* recording assets acquired by such leases.
2. The case for recording assets acquired by such leases rests primarily on the belief that the opportunity to exercise the right of use creates an asset that should be recognized in the accounts with its related liability. Discuss the arguments that *support* this belief.

Examination, November, 1966

EXAMINATION IN ACCOUNTING PRACTICE—PART I

November 2, 1966; 1:30 to 6:00 p.m.

All problems are required.

Number 1 (Estimated time—50 to 60 minutes)

The following trial balance was prepared by the Corporation's bookkeeper:

Supersonic Meteor Development Corporation
GENERAL LEDGER TRIAL BALANCE
December 31, 1965

Account	*Debit*	*Credit*
Cash	$ 122,430	
Accounts receivable	201,370	
Investments	1,450,000	
Machinery and equipment	603,000	
Accumulated depreciation—machinery and equipment		$ 204,600
Accounts payable		249,700
Bonds payable		196,000
Premium on bonds payable		8,700
Common stock ($10 par)		300,000
Retained earnings		1,050,000
Sales		1,400,000
Cost of sales	900,000	
Interest expense (net of amortization of bond premium—$1,200)	12,300	
Depreciation	65,000	
Other operating expenses	250,000	
Loss on disposal of machinery and equipment	20,400	
Loss on retirement of bonds	1,000	
Dividends received		200,000
Interest income		16,500
	$3,625,500	$3,625,500

The following facts are available:

1. The Company was founded in 1960 to develop methods of exploring outer space.
2. On January 1, 1965 the Corporation traded in a telescope which had been

purchased in 1961 for a new one. The adjusted basis of the old telescope was $60,000. The list price of the new telescope was $120,000. The Corporation paid $80,000 in addition to the old telescope for the new one. The new telescope has a useful life of eight years and no salvage value. Depreciation of $15,000 computed under the straight-line method was provided on the new telescope for 1965. Management prefers not to take the additional first-year depreciation on the new telescope.

3. On June 30, 1965 Mr. Slick, President of the Corporation, in a nontaxable exchange, transferred a rocket projector which he personally owned to the Corporation for 1,000 shares of stock. At the time of the transfer the projector had an adjusted basis to Mr. Slick of $20,000, a fair market value of $30,000, a useful life of four years and no salvage value. Depreciation of $2,500 was provided for 1965.
4. On June 30, 1965 a fuel tank which had been acquired new on June 30, 1964 for $40,000 was sold for $35,700. A ten-year useful life had been used to compute depreciation for this tank under the straight-line method; no salvage value had been anticipated. No depreciation had been recorded for this tank in 1965. The loss on its sale was computed as $400 based on an adjusted basis at December 31, 1964 of $36,100. The additional first-year depreciation had been taken.
5. On March 31, 1965 the Corporation redeemed $100,000 face value of its bonds outstanding for $105,000. On March 31, 1963 the Corporation had issued to unrelated individuals 6% debenture bonds due March 31, 1973 with a face value of $300,000 at 104 (for $312,000). The bookkeeper charged the original issuance price to the Bonds Payable account and recorded a loss of $1,000 on the repurchase of the bonds (repurchase price $105,000 less original issuance price $104,000).
6. The loss on disposal of machinery and equipment was the total of the following two losses:

Loss on trade-in of telescope	$20,000
Loss on sale of fuel tank	400
Total	$20,400

7. The dividend income was received from nonaffiliated United States corporations.
8. The interest income was earned from the following investments in bonds:

	Book Value	*Interest Income*
U.S. Government (issued after March 1, 1941)	$200,000	$ 7,000
American Telephone and Telegraph	150,000	6,000
City of Chicago, Illinois	100,000	3,500
	$450,000	$16,500

Required:

Prepare a schedule computing the income tax liability for 1965 for Supersonic Meteor Development Corporation. Supporting schedules should be in good form. Include a schedule showing your calculation of the deduction for interest expense.

1965 Tax Rates

Normal tax	22%
Surtax on income in excess of $25,000	26%

Number 2 (Estimated time—40 to 50 minutes)

The president of Eastern Company wants guidance on the advisability of eliminating product C, one of the Company's three similar products, or investing in new machinery to reduce the cost of product C in the hope of reversing product C's operating loss sustained in 1966. The three similar products are manufactured in a single plant in about the same amount of floor space and the markets in which they are sold are very competitive.

Below is the condensed statement of operating income for the Company and for product C for the year ended October 31, 1966.

Eastern Company

STATEMENT OF OPERATING INCOME

For the year ended October 31, 1966

	All Three Products	*Product C*
Sales	$2,800,150	$350,000
Cost of sales:		
Raw materials	565,000	80,000
Labor		
Direct	1,250,000	150,000
Indirect	55,000	18,000
Fringe benefits (15% of labor)	195,750	25,200
Royalties (1% of product C sales)	3,500	3,500
Maintenance and repairs	6,000	2,000
Factory supplies	15,000	2,100
Depreciation (straight-line)	25,200	7,100
Electrical power	25,000	3,000
Scrap and spoilage	4,300	600
Total cost of sales	2,144,750	291,500
Gross profit	655,400	58,500
Selling, general and administrative expenses:		
Sales commissions	120,000	15,000
Officers' salaries	32,000	10,500
Other wages and salaries	14,000	5,300
Fringe benefits (15% of wages, salaries and commissions)	24,900	4,620
Delivery expense	79,500	10,000
Advertising expense	195,100	26,000
Miscellaneous fixed expenses	31,900	10,630
Total selling, general and administrative expenses	497,400	82,050
Operating income (loss)	$ 158,000	$(23,550)

Required: (Disregard income taxes.)

a. Prepare a schedule showing the contribution of product C to the recovery of fixed costs and expenses (marginal income) for the year ended October 31, 1966. Assume that each element of cost and expense is entirely fixed or variable within the relevant range and that the change in inventory levels has been negligible.

b. Assume that in fiscal 1966 the variable costs and expenses of product C totaled $297,500 and that its fixed costs and expenses amounted to $75,100. Prepare a schedule computing the breakeven point of product C in terms of annual dollar sales volume. Sales for 1966 amounted to $350,000.

c. The direct labor costs of product C could have been reduced by $75,000 and the indirect labor costs by $4,000 by investing an additional $340,000 (financed with 5% bonds) in machinery with a ten-year life and an estimated salvage value of $30,000 at the end of the period. However, the Company would have been liable for total severance pay costs of $18,000 (to be amortized over a five-year period), and electrical power costs would have increased $500 annually.

Assuming the information given above in part "b" prepare a schedule computing the breakeven point of product C in terms of annual dollar sales volume if the additional machinery had been purchased and installed at the beginning of the year.

Number 3 (Estimated time—40 to 50 minutes)

During 1965 Amx Finance Co. began leasing equipment to small manufacturers. Information regarding leasing arrangements follows:

1. Amx Finance Co. leases equipment with terms from three to five years depending upon the useful life of the equipment. At the expiration of the lease, the equipment will be sold to the lessee at 10% of the lessor's cost, the expected salvage value of the equipment.
2. The amount of the lessee's monthly payment is computed by multiplying the lessor's cost of the equipment by the payment factor applicable to the term of lease.

Term of lease	*Payment factor*
3 years	3.32%
4 years	2.63%
5 years	2.22%

3. The excess of the gross contract receivable for equipment rentals over the cost (reduced by the estimated salvage value at the termination of the lease) is recognized as revenue over the term of the lease under the sum-of-the-digits method computed on a monthly basis.
4. The following leases were entered into during 1965:

Machine	*Dates of Lease*	*Period of Lease*	*Machine Cost*
Die	7/1/65 - 6/30/69	4 years	$45,000
Press	9/1/65 - 8/31/68	3 years	$30,000

Required:

a. Prepare a schedule of gross contracts receivable for equipment rentals at the dates of the lease for the die and press machines.

b. Prepare a schedule of unearned lease income at December 31, 1965 for each machine lease.

c. Prepare a schedule computing the present dollar value of contracts receivable for equipment rentals at December 31, 1965. (The present dollar value of the "contracts receivable for equipment rentals" is the outstanding amount of the gross contracts receivable less the unearned lease income included therein.) Without prejudice to your solution to part "b," assume that the unearned lease income at December 31, 1965 was $14,500.

Number 4 (Estimated time—40 to 50 minutes)

Smitters Corp. has various long-term investments and maintains its books on the accrual basis. The books for the year ended December 31, 1965 have not been closed. An analysis of the Investment account for the year follows:

Smitters Corp.

ANALYSIS OF INVESTMENT ACCOUNT

Year Ended December 31, 1965

		Account Per Books		
1965	*Transactions*	*Fol.*	*Debit*	*Credit*
Jan. 1	5,000 shares Backand Oil Co.		$ 5,000	
	1,000 shares General Corp.		33,500	
	50 shares, 6% Pfd. Grey Steel		6,000	
	$10,000 4% bonds, Martin Co.		10,225	
Feb. 10	Purchased 5,000 shares, Wash Motors	CD	15,000	
Mar. 1	Cash dividend, Grey Steel	CR		$ 300
April 1	Interest, Martin Co. bonds	CR		200
May 15	Sold 800 rights, General Corp.	CR		1,200
May 16	Exercised 200 rights, General Corp. to purchase 50 shares, General Corp.	CD	2,250	
Aug. 5	Sold 200 shares, Wash Motors	CR		2,500
Sept. 18	Sold 100 shares, General Corp.	CR		3,350
Oct. 1	Interest, Martin Co. bonds			200
			$71,975	$7,750

Your workpapers for the year ended December 31, 1964 show the following securities in the Investment account:

Date of Acquisition	*Number of Shares or Face Value of Bonds*	*Type of Security*	*Name of Issuer*	*Amount*
Jan. 2, 1957	5,000	Common stock, no par value	Backand Oil Co.	$ 5,000
April 1, 1958	1,000	Common stock, $100 par value	General Corp.	33,500
Nov. 15, 1958	50	6% preferred stock, par value $100	Grey Steel	6,000
Oct. 1, 1963	$10,000	4% bonds	Martin Co.	10,225
				$54,725

After inquiry the following additional data were obtained:

1. The General Corp. on May 12 issued warrants representing the right to purchase, at $45 per share, one share for every four shares held. On May 12 the market value of the stock rights-on was $50 and ex-rights was $49. Smitters Corp. sold 800 rights on May 15 when the market price of the stock was $51. On May 16, 200 rights were exercised.

2. On June 30 Wash Motors declared a reverse stock split of 1 for 5. One share of new $.50 par value common was exchanged for 5 shares of old $.10 par value common.

3. Smitters Corp. acquired the Martin Co. bonds, which are due September 30, 1968, for $10,300. Interest is payable April 1 and October 1.

4. The sale of 100 shares of General Corp. stock was part of the 1,000 shares purchased on April 1, 1958. The stock was sold for $65 per share.

5. The government of Backand in early 1965 confiscated the assets of the Backand Oil Co. and nationalized the Company. Despite the protest of the United States government, the Backand government has refused to recognize any claims of the stockholders or management of the Backand Oil Co.

Required:

Prepare a worksheet showing the adjustments to arrive at the correct balance at December 31, 1965 in the Investment account. The worksheet should include the names of other accounts affected by the adjustments or reclassifications. (Formal journal entries are not required. Supporting computations should be in good form.)

Number 5 (Estimated time—50 to 60 minutes)

The Metro Construction Company commenced doing business in January 1965. Construction activities for the year 1965 are summarized below:

Project	Total Contract Price	Contract Expenditures to Dec. 31, 1965	Estimated Additional Costs to Complete Contracts	Cash Collections to Dec. 31, 1965	Billings to Dec. 31, 1965
A	$ 310,000	$187,500	$ 12,500	$155,000	$155,000
B	415,000	195,000	255,000	210,000	249,000
C	350,000	320,000	—	300,000	350,000
D	300,000	16,500	183,500	—	4,000
	$1,375,000	$719,000	$451,000	$665,000	$758,000

The Company is your client. The president has asked you to compute the amounts of revenue for the year ended December 31, 1965 that would be reported under the completed-contract method and the percentage-of-completion method of accounting for long-term contracts.

The following information is available:

1. All contracts are with different customers.

2. Any work remaining to be done on the contracts is expected to be completed in 1966.

3. The Company's accounts have been maintained on the completed-contract method.

Required:

a. Prepare a schedule computing the amount of revenue by project for the year ended December 31, 1965 that would be reported under

1. The completed-contract method.
2. The percentage-of-completion method.

b. Prepare a schedule under the completed-contract method computing the amounts that would appear in the Company's balance sheet at December 31, 1965 for (1) costs in excess of billings, and (2) billings in excess of costs.

c. Prepare a schedule under the percentage-of-completion method that would appear in the Company's balance sheet at December 31, 1965 for (1) costs and estimated earnings in excess of billings, and (2) billings in excess of costs and estimated earnings.

d. The Company adopted the percentage-of-completion method for financial reporting purposes and the completed-contract method for income tax purposes. Assume that income before provision for taxes for the year ended December 31, 1965 under the percentage-of-completion method is $80,000 and the taxable income is $20,000. The income tax rate is 50%. Prepare the journal entry that you would recommend to record the income tax liability at December 31, 1965.

EXAMINATION IN ACCOUNTING PRACTICE—PART II

November 3, 1966; 1:30 to 6:00 p.m.

GROUP I

Solve all problems in this group.

Number 1 (Estimated time—30 to 40 minutes)

Instructions

The following questions pertain to the taxation of partnerships.

On a separate answer sheet write the letter of your answer choice for each of the following questions. The answers should be selected in accordance with the current *Internal Revenue Code* and *Regulations*. Select only one answer for each question. Your grade will be determined from your total score of correct answers.

An example of the manner in which the questions should be answered is shown in the following illustration:

Question

XX. In computing the ordinary income of a partnership for tax purposes the following deduction is not allowed:

a. Business rent.
b. State business tax.
c. Standard deduction.
d. Salaries to employees.
e. None of the above.

Answer Sheet

XX c.

Questions to be Answered

1. At the end of each tax year a partnership should file a return reporting income
   a. And pay a tax at the same tax rates as individuals who are single persons.
   b. And pay a tax at the same tax rates as corporations.
   c. Only when the partnership realizes income but pay no tax.
   d. But pay no tax.
   e. None of the above.

2. In 1965 the partnership of Hatcher and Derone realized an ordinary loss of $60,000. The partnership and the partners are on a calendar year basis. At Dec. 31, 1965 James Hatcher had an adjusted basis of $20,000 for his interest in the partnership before taking the 1965 loss into consideration. Hatcher has a 50% interest in the profits and losses of the partnership.
   On his personal income tax return for 1965, Hatcher should deduct
   a. An ordinary loss of $20,000.
   b. An ordinary loss of $30,000.
   c. An ordinary loss of $20,000 and a capital loss of $10,000.
   d. A capital loss of $30,000.
   e. None of the above.

3. Hobbs, Malone and Ritter purchased 400 shares of common stock in the Bluewater Boat Co. on April 20, 1961 for $4,000. The partnership sold these 400 shares for $2,500 on July 14, 1965. Ritter owns a 20% interest in the profits and capital of the partnership. Ritter purchased 400 shares of common stock in the Bluewater Boat Co. on July 27, 1965 for $2,600.
   As a result of selling the stock, the partnership realized
   a. No recognized loss.
   b. A long-term loss of $1,200.
   c. A long-term loss of $1,400.
   d. A long-term loss of $1,500.
   e. None of the above.

4. The partnership of Dunn and Davies uses the accrual method of accounting.
   a. Dunn must use the accrual method for his personal income tax return.
   b. Dunn may use the cash method for his personal income tax return only if his tax year does not end on the same day as the partnership's tax year.
   c. Dunn may use the cash method for his personal income tax return only if Davies also uses the cash method.
   d. Dunn may use the cash method for his personal income tax return.
   e. None of the above.

5. The partnership of Meeker and Taylor has a fiscal year ending March 31. Donald Meeker files his tax return on a calendar year basis. The partnership paid Meeker a guaranteed salary of $500 per month during the calendar year 1964 and $750 a month during the calendar year 1965. After deducting this salary, the partnership realized ordinary income of $40,000 for the year ended March 31, 1965 and $60,000 for the year ended March 31, 1966. Meeker's share of

the profits is the salary paid to him plus 30% of the partnership profits after deducting this salary.

For 1965 Meeker should report taxable income of

a. $18,750.
b. $20,250.
c. $21,000.
d. $22,500.
e. None of the above.

6. Albert Powers and Harold Lance, partners in the Jupiter Company, share profits equally. The two partners and the partnership have tax years ending December 31. The partnership realized ordinary income of $40,000 in 1965. During 1965 Powers withdrew $12,000 from the partnership.

For 1965 Powers has taxable income of

a. $ 8,000.
b. $12,000.
c. $20,000.
d. $32,000.
e. None of the above.

7. The partnership of Miner and Miller realize the following items of income during the taxable year:

Net income from sales	$40,000
Dividends from domestic corporations	5,000
Interest on corporate bonds	3,000
Net long-term capital gains	4,000
Net short-term capital gains	2,000
Net rental income	8,000

The total income which should be reported as ordinary income of the partnership is

a. $48,000.
b. $51,000.
c. $53,000.
d. $56,000.
e. None of the above.

8. As a result of incurring the following expenses and losses,

Salaries paid (other than to partners)	$40,000
Interest paid (other than to partners)	2,000
Real estate taxes	6,000
Contributions	1,000
Repairs	5,000
Foreign income taxes	3,000
Loss on the sale of a machine held six years	8,000

the Excelsior Company, a partnership, should reduce its ordinary income by

a. $51,000.
b. $53,000.

c. $61,000.
d. $64,000.
e. None of the above.

9. On Sept. 1, 1965 Max Ladig contributed a factory building to the Olympic Company for an additional partnership interest. Ladig had purchased this building in 1955 for $60,000. When Ladig became a partner in the Olympic Company on March 1, 1963, the building had an adjusted basis to him of $47,750 and a fair market value of $75,000.

The tax basis of the building to the partnership is
a. $45,500.
b. $47,750.
c. $60,000.
d. $75,000.
e. None of the above.

10. Refer to item "9" above. As a result of the transfer of the building to the partnership, Ladig realized a taxable gain of
a. $15,000.
b. $22,250.
c. $27,250.
d. $29,500.
e. None of the above.

11. Refer to item "9" above. On Nov. 9, 1965 the Olympic Company sold the building for $85,000. This was the only fixed asset disposed of in 1965. Disregarding any recapture of depreciation, the transaction would be reported as
a. A long-term capital gain.
b. A short-term capital gain.
c. Ordinary income.
d. No taxable gain.
e. None of the above.

12. The partners of the Progressive Trading Co. and their profit and loss ratios are: Filmore, 80%; and Casper, 20%. Filmore is married and files a joint return with his wife, and Casper is single. The partnership purchased a new machine in 1965 with an estimated useful life of ten years for $40,000.

The 1965 additional first-year depreciation allowance available to the partners is
a. $2,000.
b. $5,600.
c. $6,000.
d. $8,000.
e. None of the above.

13. Refer to item "12" above. In determining its ordinary income (or loss) the Progressive Trading Co. is entitled to a deduction for personal exemptions of
a. $ 300.
b. $ 600.
c. $1,200.

d. $1,800.
e. None of the above.

14. The balance sheet of the Universal Machine Co. at Dec. 31, 1965 and the related fair market values are:

	Assets			*Capital*	
	Book Value	*Market Value*		*Book Value*	*Market Value*
Cash	$ 20,000	$ 20,000	Blake, Capital	$ 60,000	$ 90,000
Accounts receivable	30,000	30,000	Jones, Capital	30,000	45,000
Machinery	70,000	130,000	Lorn, Capital	30,000	45,000
	$120,000	$180,000		$120,000	$180,000

Lorn retired from the partnership on Dec. 31, 1965, at which time the basis for his partnership interest was $30,000. Lorn will receive $15,000 in cash per year for four years in complete payment for his interest.

During this four-year period, Lorn will realize (disregard any recapture of depreciation)

a. Capital gain of $15,000.
b. Capital gain of $30,000.
c. Ordinary income of $30,000.
d. Capital gain of $15,000 and ordinary income of $15,000.
e. None of the above.

15. Howard Olson has conducted his hardware store business as a sole proprietorship for twenty years. On May 1, 1965 he gave a one-fourth interest in this business to his son, John.

After the transfer of this one-fourth interest, the business

a. Will be considered a partnership for Federal income tax purposes only if the son works in the hardware store.
b. Will be considered a partnership for Federal income tax purposes only if the son gives his father a promissory note for the value of the interest transferred to him.
c. Will be considered a partnership for Federal income tax purposes only if the son is the bona fide owner of the interest which was said to have been transferred to him.
d. Will not be considered a partnership for Federal income tax purposes.
e. None of the above.

16. The balance sheet of Adams, Bryson and Grant at Sept. 30, 1965 and the related fair market values are:

	Assets			*Capital*	
	Book Value	*Market Value*		*Book Value*	*Market Value*
Cash	$15,000	$ 15,000	Adams, Capital	$20,000	$ 40,000
Inventory	10,000	40,000	Bryson, Capital	20,000	40,000
Machinery	35,000	65,000	Grant, Capital	20,000	40,000
	$60,000	$120,000		$60,000	$120,000

The partnership distributed to Grant all of the inventory in complete liquidation of his interest. The partnership realized (disregard any recapture of depreciation)

a. No taxable gain.
b. A capital gain of $20,000.
c. Ordinary income of $20,000.
d. Ordinary income of $30,000.
e. None of the above.

17. The Daniel Brothers, a four-man partnership, received dividend income of $1,000 from taxable domestic corporations during 1965. The amount of the dividend exclusion to be claimed on the partnership return for 1965 is:

a. $400.
b. $200.
c. $100.
d. $ 50.
e. None of the above.

18. Dynamic Enterprises is classified as a limited partnership according to the laws of the state in which it was formed. The partnership agreement provides that a partner may transfer his interest to an outside individual without the consent of the other partners and that the death, withdrawal or admission of a partner will not dissolve the business. According to the laws of this state, the partners cannot be held personally liable for an amount greater than their partnership interests if the business should become insolvent.

For Federal income tax purposes, Dynamic Enterprises would be considered a

a. Partnership.
b. Corporation.
c. Trust.
d. Joint venture.
e. None of the above.

19. Richard Dolan has a 40% interest in Ace Markets, a partnership which operates a chain of grocery stores. In 1961 Dolan purchased 100 shares of Electro Enterprises, Inc. common stock for $10,000. In 1965 he sold these 100 shares to Ace Markets for $7,000.

On his personal income tax return for 1965, Dolan would report

a. No deductible loss.
b. A long-term capital loss of $1,200.
c. A long-term capital loss of $3,000.
d. An ordinary loss of $3,000.
e. None of the above.

20. Paul Jordan and Bill Burke formed a partnership on July 1, 1965. Both partners file their personal Federal income tax returns on a calendar year basis, and both plan to continue this practice in the future.

For Federal income tax purposes the partnership may adopt a fiscal year ending June 30

a. Only if all other partnerships, of which Jordan and Burke are partners, have June 30 fiscal years.
b. Only if that period would be considered the partnership's natural business year.
c. Only if the partnership obtains permission from the Commissioner of Internal Revenue to do so.
d. Under no circumstances.
e. None of the above.

Number 2 (Estimated time—50 to 60 minutes)

The preclosing general ledger trial balances at December 31, 1965 for the Baltimore Wholesale Co. and its Atlanta Branch Office are shown below.

Baltimore Wholesale Co.
GENERAL LEDGER TRIAL BALANCE
December 31, 1965

Accounts	*Home Office* *Dr. (Cr.)*	*Branch Office* *Dr. (Cr.)*
Cash	$ 36,000	$ 8,000
Accounts receivable	35,000	12,000
Inventory—Home Office	70,000	
Inventory—Branch Office		15,000
Fixed assets, net	90,000	
Branch Office	20,000	
Accounts payable	(36,000)	(13,500)
Accrued expenses	(14,000)	(2,500)
Home Office		(9,000)
Capital stock	(50,000)	
Retained earnings	(45,000)	
Home Office:		
Sales	(440,000)	
Purchases	290,000	
Expenses	44,000	
Branch Office:		
Sales		(95,000)
Purchases		24,000
Purchases from Home Office		45,000
Expenses		16,000
	—0—	—0—

Your audit disclosed the following:

1. On December 23 the Branch Office manager purchased $4,000 of furniture and fixtures but failed to notify the Home Office. The bookkeeper, knowing that all fixed assets are carried on the Home Office books, recorded the proper entry on the Branch Office records. It is the Company's policy not to take any depreciation on assets acquired in the last half of year.

2. On December 27 a Branch Office customer erroneously paid his account of $2,000 to the Home Office. The bookkeeper made the correct entry on the Home Office books but did not notify the Branch Office.

3. On December 30 the Branch Office remitted cash of $5,000 which was received by the Home Office in January 1966.

4. On December 31 the Branch Office erroneously recorded the December allocated expenses from the Home Office as $500 instead of $1,500.

5. On December 31 the Home Office shipped merchandise billed at $3,000 to the Branch Office, which was received in January 1966.

6. The entire opening inventory of the Branch Office had been purchased from the Home Office. Home Office 1965 shipments to the Branch Office were purchased by the Home Office in 1965. The physical inventories at December 31, 1965, excluding the shipment in transit, are:

Home Office—$55,000 (at cost)
Branch Office—$20,000 (comprised of $18,000 from Home Office and $2,000 from outside vendors).

7. The Home Office consistently bills shipments to the Branch Office at 20% above cost. The Sales account is credited for the invoice price.

Required: (Disregard income taxes.)

Prepare a worksheet showing Adjustments and Eliminations, Home Office Income Statement, Branch Office Income Statement, and Combined Balance Sheet. The Branch Office income data should be on the basis of Home Office cost. Number your worksheet adjusting and eliminating entries. (Formal journal entries are not required. Supporting computations, including the computation of the ending inventories, must be in good form.)

Number 3 (Estimated time—40 to 50 minutes)

Near the close of your audit, the Treasurer of Ezy Corporation, your client, informs you that the Company is planning to acquire the ATU Corporation and requests that you prepare certain financial statistics for 1965 and 1964 from the following statements of ATU Corporation.

ATU Corporation
BALANCE SHEET
December 31, 1965 and 1964

ASSETS	*1965*	*1964*
Current assets:		
Cash	$ 1,610,000	$ 1,387,000
Marketable securities, at cost (market value $550,000)	510,000	
Accounts receivable, less allowance for bad debts: 1965, $125,000; 1964, $110,000	4,075,000	3,669,000
Inventories, at lower of cost or market	7,250,000	7,050,000
Prepaid expenses	125,000	218,000
Total current assets	13,570,000	12,324,000
Plant and equipment, at cost:		
Land and buildings	13,500,000	13,500,000
Machinery and equipment	9,250,000	8,520,000
Total plant and equipment	22,750,000	22,020,000
Less allowances for depreciation	13,470,000	12,549,000
Total plant and equipment—net	9,280,000	9,471,000
Long term receivables	250,000	250,000
Deferred charges	25,000	75,000
Total assets	$23,125,000	$22,120,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 2,950,000	$ 3,426,000
Accrued expenses	1,575,000	1,644,000
Federal taxes payable	875,000	750,000
Current maturities on long-term debt	500,000	500,000
Total current liabilities	5,900,000	6,320,000
Other liabilities:		
5% sinking fund debentures, due January 1, 1976 ($500,000 redeemable annually)	5,000,000	5,500,000
Deferred taxes on income, related to depreciation	350,000	210,000
Total other liabilities	5,350,000	5,710,000
Shareholders' equity:		
Capital stock:		
Preferred stock, $1 cumulative, $20 par, preference on liquidation $100 per share (authorized: 100,000 shares; issued and outstanding: 50,000 shares)	1,000,000	1,000,000
Common stock, $1 par (authorized: 900,000 shares; issued and outstanding: 1965, 550,000 shares; 1964, 500,000 shares)	550,000	500,000
Capital in excess of par value of common stock	3,075,000	625,000
Retained earnings	7,250,000	7,965,000
Total shareholders' equity	11,875,000	10,090,000
Total liabilities and stockholders' equity	$23,125,000	$22,120,000

ATU Corporation
STATEMENT OF INCOME AND RETAINED EARNINGS
For the Years Ended December 31, 1965 and 1964

	1965	*1964*
Income:		
Net sales	$48,400,000	$41,700,000
Royalties	70,000	25,000
Interest	30,000	
Total	48,500,000	41,725,000
Costs and expenses:		
Cost of sales	31,460,000	29,190,000
Selling, general and administrative	12,090,000	8,785,000
Interest on 5% sinking fund debentures	275,000	300,000
Provision for Federal income taxes	2,315,000	1,695,000
Total	46,140,000	39,970,000
Net income	2,360,000	1,755,000
Retained earnings, beginning of year	7,965,000	6,760,000
Total	10,325,000	8,515,000
Dividends paid:		
Preferred stock, $1.00 per share in cash	50,000	50,000
Common stock:		
Cash—$1.00 per share	525,000	500,000
Stock—(10%)—50,000 shares at market value of $50 per share	2,500,000	
Total	3,075,000	550,000
Retained earnings, end of year	$ 7,250,000	$ 7,965,000

Additional information:

1. The inventory at January 1, 1964 was $6,850,000.
2. The market prices of the common stock at December 31, 1965 and 1964 were $73.50 and $47.75 respectively.
3. The cash dividends for both preferred and common stock were declared and paid in June and December of each year. The stock dividend on common stock was declared and distributed in August 1965.
4. Plant and equipment sales and retirements during 1965 and 1964 were $375,000 and $425,000 respectively. The related depreciation allowances were $215,000 in 1965 and $335,000 in 1964. At December 31, 1963 the plant and equipment asset balance was $21,470,000 and the related depreciation allowances were $11,650,000.

Required:

Prepare a schedule computing the following selected statistics for 1965 and 1964. The current equivalent number of shares outstanding as of the respective year-end dates should be utilized in computing per share statistics. (The current equivalent shares means the number of shares outstanding in the prior period in terms of the present stock position.)

At December 31:
1. Current ratio.
2. Acid test (quick) ratio.
3. Book value per common share.

Year ended December 31:
1. Gross margin rate.
2. Inventory turnover rate.
3. Times interest earned (before taxes).
4. Earnings per common share.
5. Common stock price-earnings ratio (end of year value).
6. Gross capital expenditures.

Number 4 (Estimated time—50 to 60 minutes)

Engler Corporation's actual and standard distribution costs data for the month of January 1966 follow:

	Budget at Standard Cost	*Actual Operations*
Sales	$750,000	$750,000
Direct distribution costs:		
Selling	$ 12,000	$ 15,000
Shipping salaries	7,000	9,450
Indirect distribution costs:		
Order filling	17,250	21,500
Other	2,100	2,500
Total costs	$ 38,350	$ 48,450

Additional data:
1. Engler Corporation sells a single product for $10 per unit.
2. Shipping Salaries and Indirect Distribution Costs-Other are allocated on the basis of shipping hours.
3. January shipping hours data follow:

	Shipping Hours
Budgeted	3,500
Standard operating level	4,400
Actual	4,500

4. Order-Filling costs are allocated on the basis of sales and are comprised of freight, packing, and warehousing costs. An analysis of the amount of these standard costs by unit order-size follows:

	Order-Filling Standard Costs Classified by Unit Order Size			
Unit-Volume Classifications	*1-15*	*16-50*	*Over 50*	*Total*
Freight	$ 1,200	$ 1,440	$ 2,250	$ 4,890
Packing	2,400	3,240	4,500	10,140
Warehousing	600	720	900	2,220
Total	$ 4,200	$ 5,400	$ 7,650	$17,250
Units sold	12,000	18,000	45,000	75,000

Required:

a. Compute and analyze variances from standard cost for
   1. Shipping Salaries and
   2. Indirect Distribution Costs-Other. Use the two-variance method. The analysis should compare actual costs and standard costs at the standard operating level.

b. Management realizes that the distribution cost per unit decreases with an increase in the size of the order and, hence, wants to revise its unit sales prices upward or downward on the basis of the quantity ordered in proportion to the allocated freight, packing, and warehousing standard costs. Management assumes that the revised unit prices will require no changes in standards for sales volume, the number of units sold in each order-size classification and the profit per unit sold.
   1. For each unit volume classification, prepare a schedule computing the standard cost per unit for each order-filling cost: freight, packing, and warehousing. Use the format in item #4 above for this schedule.
   2. Prepare a schedule computing the revised unit sales prices for each unit-volume classification.

GROUP II

Estimated time—50 to 60 minutes.

Solve one of the two problems in this group. If both are solved, only the first will be considered.

Number 5

The Tudor Corporation adopted a qualified profit-sharing plan for its employees on January 1, 1956. The trust agreement contains the following provisions:

1. For each year in which the amount of eligible net earnings equals or exceeds the profit-sharing base for that year, the Corporation shall remit to the Trustee an amount equal to 5 per cent of the profit-sharing base for the year plus 10 per cent of any eligible net earnings for the year in excess of the base.

2. "Eligible net earnings" with respect to any year shall be net income for the year after deducting the payment to the Trustee and the provision for Federal income taxes.

3. An employee shall be eligible to participate in the plan on January 1 of the year following the completion of one full year of employment.

4. The annual payment to the Trustee shall be allocated to the interests of the participants according to the following unit system:
   a. For each full calendar year of employment under the plan each participant shall be entitled to eight units.
   b. For each $10.00 of average weekly pay earned in the current year, based on a 52-week year, the employee shall be entitled to one unit.

5. Ten per cent of a participant's total interest is vested for each full year of his participation in the plan.

6. Forfeitures and investment income will be distributed to the remaining participants at the end of each year in proportion to their interests in the plan at the beginning of the year.

In the course of your audit of Tudor Corporation as of December 31, 1965 you find that the Trustee has submitted the trial balance below but that the Corporation's 1965 contribution to the trust has not been computed and allocated to the participants.

Tudor Corporation

Profit-Sharing Trust

TRIAL BALANCE

December 31, 1965

	Debit	*Credit*
Cash	$ 500	
Investment, 1/1/65	26,000	
R. Johnson's interest, 1/1/65		$ 6,512
K. Kegler's interest, 1/1/65		5,984
J. Wright's interest, 1/1/65		7,500
M. Penny's interest, 1/1/65		5,104
Investment income for 1965		1,400
	$26,500	$26,500

The following information also is available.

Employee	*Date Employed*	*Date Terminated*	*1965 Salary*
R. Johnson	12/8/55		$ 8,320
K. Kegler	7/1/56		7,280
J. Wright	11/20/56	8/1/65	6,200
M. Penny	9/15/61		5,200
J. Rawlings	8/20/64	12/26/65	800
A. Morris	5/5/64		1,100
			$28,900

The 1965 net income for Tudor Corporation before deducting the payment to the Trustee and the provision for Federal income taxes is $88,500.

Required:

a. Assume that the profit-sharing base for 1965 is $30,000 and the income tax rate is 50%. Compute the Corporation's 1965 contribution to the trust.

b. Assume that the answer to part "a" is $4,000. Prepare a schedule allocating the 1965 contribution to the various participants.

c. Prepare a schedule allocating the amount of any forfeitures and investment income to the remaining participants.

Number 6

The City of New Arnheim has engaged you to examine the following balance sheet which was prepared by the City's bookkeeper:

City of New Arnheim
BALANCE SHEET
June 30, 1966

Assets	
Cash	$ 159,000
Taxes receivable—current	32,000
Supplies on hand	9,000
Marketable securities	250,000
Land	1,000,000
Fixed assets	7,000,000
Total	$8,450,000
Liabilities	
Vouchers payable	$ 42,000
Reserve for supplies inventory	8,000
Bonds payable	3,000,000
Unappropriated surplus	5,400,000
Total	$8,450,000

Your audit disclosed the following information:

1. An analysis of the Unappropriated Surplus account:

Balance, June 30, 1965		$2,100,000
Add:		
Donated land	$ 800,000	
Federal grant-in-aid	2,200,000	
Creation of endowment fund	250,000	
Excess of actual tax revenue over estimated revenue	24,000	
Excess of appropriations closed out over expenditures and encumbrances	20,000	
Net income from endowment funds	10,000	3,304,000
		5,404,000
Deduct:		
Excess of Cultural Center operating expenses over income		4,000
Balance, June 30, 1966		$5,400,000

2. In July 1965 land, appraised at a fair market value of $800,000, was donated to the City for a Cultural Center which was opened on April 15, 1966. Building construction expenditures for the project were financed from a Federal grant-in-aid of $2,200,000 and from an authorized 10-year $3,000,000 issue of 3% general obligation bonds sold at par on July 1, 1965. Interest is payable on December 31 and June 30. The fair market value of the land and the cost of

the building are included respectively in the Land and Fixed Assets accounts.

3. The Cultural Center receives no direct state or city subsidy for current operating expenses. A Cultural Center Endowment Fund was established by a gift of marketable securities having a fair market value of $250,000 at date of receipt. The endowment principal is to be kept intact. Income is to be applied to any operating deficit of the Center.

4. Other data:
   a. It is anticipated that $7,000 of the 1965-66 tax levy is uncollectible.
   b. The physical inventory of supplies-on-hand at June 30, 1966 amounted to $12,500.
   c. Unfilled purchase orders for the General Fund at June 30, 1966 totaled $5,000.
   d. On July 1, 1965, an all-purpose building was purchased for $2,000,000. Of the purchase price, $200,000 was allotted to the land. The purchase had been authorized under the budget for the year ended June 30, 1966.

Required:

Prepare a worksheet showing adjustments and distributions to the proper funds or groups of accounts. The worksheet should be in the form of the City of New Arnheim's balance sheet and have the following column headings:

1. Balance per Books.
2. Adjustments—Debit.
3. Adjustments—Credit.
4. General Fund.
5. City Cultural Center Endowment Fund:
   Principal
   Income
6. General Fixed Assets.
7. General Bonded Debt and Interest.

(Number all adjusting entries. Formal journal entries are not required. Supporting computations should be in good form.)

EXAMINATION IN AUDITING

November 3, 1966; 8:30 a.m. to 12:00 m.

All questions are required.

Number 1 (Estimated time—35 to 40 minutes)

Instructions

Select the **best** answer choice for each of the following items and write the letter of your answer choice on a separate answer sheet. Your grade will be determined from your total score of correct answers.

An example of the manner in which questions should be answered is shown in the following illustration:

Question

XX In an audit the CPA would not foot the
- a. Cash book.
- b. Chart of accounts.
- c. Payroll book.
- d. Trial balance of accounts receivable.

Answer Sheet

XX b.

Questions to be Answered

1. The date of the CPA's opinion on the financial statements of his client should be the date of:
   - a. Closing of the client's books.
   - b. Receipt of client's letter of representation.
   - c. Completion of all important audit procedures.
   - d. Submittal of the report to the client.

2. Post-balance-sheet-date events and transactions must be examined by the CPA for the following period subsequent to the balance sheet date:
   a. At least 30 days.
   b. At least 45 days.
   c. At least 60 days.
   d. A duration dependent upon the practical requirements of the examination.

3. During the course of his examination a CPA discovers specific circumstances that lead him to believe that an employee's fraud may have occurred. In such a case the CPA
   a. Should extend his procedures to determine whether fraud has in fact occurred.
   b. Should tactfully approach the supervisor of the suspected employee and attempt to resolve the matter with him.
   c. Should ascertain that the client understands that the ordinary examination is not primarily or specifically designed to disclose fraud, defalcations or other irregularities.
   d. Should, after advising the client of his findings, suggest to the client that an investigation should be made to determine whether fraud has in fact occurred.

4. For the past five years a CPA has audited the financial statements of a manufacturing company. During this period, the examination scope was limited by the client regarding the observation of the annual physical inventory. Since the CPA considered the inventories to be of material amount and he was not able to satisfy himself by other auditing procedures, he was not able to express an unqualified opinion on the financial statements in each of the five years.

The CPA was allowed to observe physical inventories for the current year ended December 31, 1965 because the client's banker would no longer accept the audit reports. In the interest of economy the client requested the CPA to not extend his audit procedures to the inventory as of January 1, 1965.

In his short-form report the CPA should mention his lack of observance of the January 1, 1965 inventory and his lack of application of other procedures to satisfy himself. He would then
   a. Issue an unqualified opinion only as to the balance sheet at December 31, 1965.
   b. Issue an unqualified opinion only as to the balance sheet at December 31, 1965 and disclaim an opinion on the results of operations.
   c. Disclaim an opinion on the balance sheet at December 31, 1965 and the results of operations for 1965 because of the significance of inventories in the determination of financial position and results of operations.
   d. Issue an unqualified opinion as to the balance sheet at December 31, 1965 and the results of operations for 1965 because his mention of the facts complies with the third standard of reporting that requires disclosure of the omission of any generally accepted auditing procedures.

5. During the course of his examination of the financial statements of a corporation for the purpose of expressing an opinion on the statements, a CPA is refused permission to inspect the minute books. The corporation secretary instead offers to give the CPA a certified copy of all resolutions and actions relating to accounting matters.

Assuming that in all other respects the client did not impose any restrictions on the CPA and that he completed his audit to his full satisfaction, what would be the effect on his short-form report of the omission of the inspection of minutes and the acceptance by the CPA of the certified copy of the minute books relating to accounting matters?

a. No effect. The CPA has complied with the third standard of field work that requires the examination of all evidential material dealing with accounting matters.
b. No effect. In the scope paragraph of his report the CPA would state that instead of inspection of minutes he accepted a certified copy of the minute books relating to accounting matters and, as to such accounting matters, has satisfied himself by other procedures.
c. The result would be a disclaimer of opinion because of limited scope of examination. The nature of information that may be disclosed as a result of an examination of minute books is of such potential importance as to demand personal inspection by the CPA.
d. The result would be a qualified opinion. In a separate paragraph in his report the CPA would state that instead of inspection of the minutes he accepted a certified copy of the minute book relating to accounting matters and, as to such accounting matters, has satisfied himself by other procedures.

6. A CPA has completed his examination of the financial statement of a bus company for the year ended December 31, 1965. Prior to 1965 the company had been depreciating its buses over a ten-year period. During 1965 the company determined that a more realistic estimated life for its buses was 12 years and computed the 1965 depreciation on the basis of the revised estimate. The CPA has satisfied himself that the 12-year life is reasonable.

The company has adequately disclosed the change in estimated useful lives of its buses and the effect of the change on 1965 income in a note to the financial statements.

With reference to this change in depreciation, the auditor's short-form report

a. Should recognize this change as one that involves a choice by management between two generally accepted principles of accounting, and contain a qualification as to consistency.
b. Should contain in the opinion paragraph: 1) a reference to the company's footnote; 2) a qualification as to the lack of consistency; 3) an expression of the auditor's approval of the change in depreciation.
c. Should include: 1) an adverse opinion; 2) reference to the change and its effect; 3) a statement by the CPA as to this exception as to fairness of presentation.
d. Should not mention the change because it results from changed conditions and is not a change in accounting principles employed. The

change is disclosed in the footnote by the company and is not in violation of the reporting standard regarding consistency.

7. The examination of the financial statements of a public utility by a CPA was conducted in accordance with generally accepted auditing standards. The only item of exception to be disclosed by the examination was the utility's use of an accounting principle concerning the matching of revenues and expenses. After careful consideration and examination the CPA concluded that the principle applied by the utility was at variance with generally accepted principles of accounting.

The utility used such a principle in accordance with the mandatory requirement of the state utility commission that regulates the utility. No other state utility commission has a similar requirement.

The variance is considered material in amount and a short-form report is being prepared for purposes other than the filing of the report with the government regulatory authority.

a. Depending upon the degree of materiality of the amount involved, the report should contain either a qualified or an adverse opinion because the first reporting standard applies not only to business enterprises in general but to companies regulated by governmental authorities as well.
b. The first reporting standard concerning the use of generally accepted principles of accounting is not intended to include public utilities which are regulated by a governmental authority, so an unqualified opinion may be issued as no other exceptions were disclosed by the examination.
c. The CPA could issue an unqualified report because the principle involved is generally followed by utility companies, and therefore the statements would be in conformity with generally accepted principles of accounting as required by the first standard of reporting.
d. If the company adds a footnote to its financial statements explaining the principle involved and the related effect upon income, the CPA need only make reference to the footnote in the scope paragraph to comply with the requirements of the third reporting standard.

8. The Tuck Company engaged a CPA to audit its financial statements at December 31, 1965. No prior audits had been made since the Company commenced operations nine years ago. The Company has kept its records and has prepared its financial statements for previous years on the cash basis with no recognition having been accorded accounts receivable, accounts payable or accrued expenses. At the beginning of the current year the Company adopted the accrual basis of accounting and made the appropriate adjustments to retained earnings as of the beginning of the year. A footnote has been added to the financial statements explaining the change and its effect. The Company has no inventories.

The Company president has asked the CPA what effect the above circumstances will have on the short-form report to be issued by the CPA. The audit for the current year has not disclosed any irregularities.

a. These circumstances would have no effect on the report and need not be mentioned in the report because the CPA is reporting only on the current year.

b. The report should disclaim an opinion and should refer to the lack of consistent application of generally accepted principles of accounting as the reason for disclaiming an opinion.
c. The report would note the change from the cash to the accrual basis of accounting, and refer to the footnote in a middle paragraph. An unqualified opinion would be issued except for the omission of the customary reference to consistency.
d. The opinion paragraph of the report will take exception to the fair presentation of financial condition, pointing out the distortion of retained earnings brought about by the adjustments made as of the beginning of the year.

9. During the course of his audit, a CPA determined that the company's inventories are stated at labor cost, material cost and that portion of manufacturing overhead which varies directly with the volume of output. The company has consistently followed the procedure of considering those elements of manufacturing overhead which are fixed in amount regardless of the level of output as period cost, and has charged them to expense in the period they are incurred. Inventory cost includes only the variable portion of manufacturing overhead. The method of valuation of inventory is fully disclosed in the statements. Except for the inventory valuation method described above, the company's financial statements are found to be acceptable in all respects.

The short-form report in the above situation

a. Will contain a disclaimer of opinion because of the lack of conformity with generally accepted principles of accounting.
b. Will contain an unqualified opinion because the reporting standard of full disclosure was fulfilled.
c. Will contain a qualified opinion or an adverse opinion because of the lack of conformity with generally accepted principles of accounting, depending upon the materiality of the amount involved.
d. Will contain a disclaimer of opinion because there is insufficient competent evidential matter available to form an opinion on the fairness of the presentation of the financial statements as a whole.

10. During a meeting with his client to discuss the short-form report prepared by a CPA in connection with his completed examination of the financial statements of the client, strong objections are raised by the client because of the adverse opinion rendered by the CPA. The financial statements reported the recording of fixed asset appraisal values substantially in excess of cost.

The client requests that an unqualified report be rendered, and when told that this is impossible, he then asks that the statements be prepared on stationery of the CPA, including the upward departure from cost, and tells the CPA that the statements may be clearly labeled "Prepared without Audit."

a. The CPA should refuse to be associated in any way with the requested statements because he cannot deny having performed an audit, nor can he overlook his audit findings.
b. The CPA can prepare the requested statements if each page is clearly marked "Prepared without Audit."
c. The request must be refused by the CPA because generally accepted

auditing standards forbid a CPA from issuing statements on his stationery that are marked "Prepared without Audit."

d. The increase in the value of all property since the end of World War II has necessitated departure from cost in order to fairly present the financial position of many companies. Therefore the recording of appraisal values is no longer considered to be a departure from generally accepted principles of accounting, and the CPA can issue the requested statements if marked clearly "Prepared without Audit," and if he also issues a disclaimer of opinion.

11. Subsequent to the date of the financial statements as part of his post-balance-sheet-date audit procedures a CPA learned of heavy damage to one of a client's two plants due to a recent fire; the loss will not be reimbursed by insurance. The newspapers described the event in detail. The financial statements and appended notes as prepared by the client did not disclose the loss caused by the fire. The CPA is now in the process of preparing his short-form report.

a. He need make no mention of the fire loss because the event has been widely publicized and interested parties may be considered as having been notified.
b. A fire loss need not be disclosed because disclosure of such event frequently creates doubt as to the reason therefor.
c. If client is not willing to disclose the fire loss in the statements or notes, the CPA should include its mention in his report, usually in a middle paragraph, to comply with the auditing standard requiring disclosure of matters essential to proper interpretation of the statements presented.
d. If the client is unwilling to disclose the fire loss in the financial statements, the auditor should withdraw from the engagement.

12. A CPA has completed his examination of the consolidated financial statements prepared by his client. The CPA did not examine the financial statement of one of the subsidiaries, but he did receive the unqualified opinion of another CPA on the subsidiary's statements. The procedures used by the client to prepare the consolidated statements have been reviewed and approved.

The principal CPA wishes to accept full responsibility for his opinion on consolidated statements and therefore has made a sufficient review of the work of the other CPA to justify his accepting full responsibility for the performance of the audit by the other CPA.

a. The principal CPA may express an unqualified opinion on the consolidated statements where there has been utilization of the report of another CPA, provided he attaches to his report the report of the other CPA.
b. The principal CPA need make no reference to the other CPA in either the scope or opinion paragraph of the report on the consolidated statements.
c. The principal CPA can issue an unqualified opinion as to the unconsolidated parent whose examination he conducted, but must qualify his opinion on the consolidated statements, as stated in the generally accepted auditing standard concerning the scope of examination.

d. Under these circumstances the principal CPA must refer to the other CPA in the scope or middle paragraph and state that he assumes full responsibility for the work of the other CPA. His opinion may then be unqualified.

13. A manufacturing company has elected to treat the investment credit arising from the purchase of assets which qualify for this credit under the terms of the *Internal Revenue Code* as a reduction in taxes otherwise applicable to the year in which the credit arises instead of reflecting the credit in net income over the life of such assets. The method has been adequately disclosed in footnotes to financial statements. In order to conform with the standards of reporting regarding the use of generally accepted principles of accounting, a CPA preparing a short-form report under the above circumstances

a. Should include a middle paragraph describing the procedure followed by the company and disclaim an opinion on the fairness of presentation of the financial statements as a whole due to this deviation from generally accepted principles of accounting.
b. Should indicate this deviation from generally accepted principles of accounting, and, depending upon the materiality of the amount involved, issue a qualified opinion or an adverse opinion.
c. Even though this method is acceptable and may be used in accordance with generally accepted principles of accounting, the CPA should disclose in the middle paragraph of his report the effect of the method elected and compare it to the effect of an alternative method. An unqualified opinion may be rendered by the CPA.
d. While the method of reporting the investment credit in net income over the life of acquired assets is considered to be preferable, the alternative method of treating the credit as a reduction of taxes of the year in which the credit arises is also acceptable, and an unqualified opinion may be rendered by the CPA.

14. A CPA is engaged in the examination of the financial statements of a large manufacturing company with branch offices in many widely separated cities. The CPA was not able to count the substantial undeposited cash receipts at the close of business on the last day of the fiscal year at all branch offices.

As an alternative to this generally accepted auditing procedure used to verify the accurate cutoff of cash receipts, the CPA observed that deposits in transit as shown on the year-end bank reconciliation appeared as credits on the bank statement on the first business day of the new year. The CPA was satisfied as to the cutoff of cash receipts by the use of the alternative procedure.

a. The limitation of scope resulting from the omission of a generally accepted auditing procedure (cash count) would require disclosure in the scope paragraph of the use of the alternative auditing procedures even though the auditor was able to satisfy himself by their application.
b. When an auditor is able to satisfy himself by the application of any alternative auditing procedures except those concerning inventories or receivables, reference to the alternative procedures is not required anywhere in the auditor's report.

c. The limitation of scope caused by the necessity to apply alternative auditing procedures would require the issuance of either a qualified opinion or a disclaimer of opinion depending upon the materiality of the amount involved.
d. Generally accepted auditing standards would permit only the issuance of a piecemeal opinion in those cases where an auditor omitted making a cash count.

15. When the CPA has not performed an audit, any financial statements with which his name is associated should be conspicuously marked on each page "Prepared without Audit." When such statements are accompanied by his explanatory comments, the CPA must

a. Include in his comments a disclaimer of opinion.
b. Include in his comments an adverse opinion.
c. Instruct the client that the statements are confidential and prepared for management purposes only.
d. Refrain from expressing an opinion.

✓ **Number 2 (Estimated time—25 to 30 minutes)**

Part a. The Hymine Manufacturing Company, Inc., which has been doing business for ten years, has engaged you to examine its financial statements. The Company has never before engaged the services of a CPA. Its Federal income tax returns have been prepared by the Company's chief accountant.

Required:

1. In an initial engagement the CPA usually applies the auditing procedure of reviewing the client's Federal income tax returns for prior years. What are the **general** purposes or objectives of this auditing procedure? (In this part do not list specific items of information available from this source.)

2. An objective of the review of prior years' income tax returns is to obtain specific items of information pertaining to the client's accounting and income tax practices. List these specific items and explain each item's relevance to the CPA's examination. (For example, prior years' income tax returns would be reviewed for any net operating loss carryover which would be applied to any income tax liability for the year under examination.)

Part b. Federal income tax returns provide for the signature of the individual or firm preparing the tax return.

Required:

Discuss whether a CPA is required to sign the tax return in each of the following independent situations:

1. The tax return was prepared by the CPA without compensation.

2. The tax return was prepared by the CPA who had rendered an adverse opinion in his auditor's report on the taxpayer's financial statements.

3. The tax return was prepared by the taxpayer's chief accountant who later

submitted the return to the CPA for his recommendations. The CPA recommended substantial changes which were adopted.

Number 3 (Estimated time—25 to 30 minutes)

In your examination of the financial statements of the Kay Savings and Loan Association for year ended December 31, 1965 you find a new account in the general ledger, Home Improvement Loans. You determine that these are unsecured loans not insured by any government agency, made on a discount basis to homeowners who are required to secure life insurance coverage provided by the Association under a group life insurance policy for the outstanding amount and duration of the loan. Borrowers are issued coupon books which require monthly installment payments, however, borrowers may prepay the outstanding balance of the loan at any time in accordance with the terms of their loan contract. This account constitutes a material amount of the total assets of the Association at December 31, 1965.

Required:

a. Prepare an audit program for the examination of the new account, Home Improvement Loans.

b. During your examination of the Home Improvement Loans account the Vice President in charge of the loan department hands you a list of 25 accounts with balances from $300 to $8,000 representing approximately 40% of the total account balance. He states that confirmation requests are not to be prepared for these 25 accounts under any circumstances because the borrowers have requested "no correspondence."

1. Would you comply with the Vice President's request? **Discuss.**
2. Assuming you complied with the Vice President's request and did not send confirmation requests to the "no correspondence" accounts, what effect, if any, would this compliance have upon your auditor's short-form report?

Number 4 (Estimated time—25 to 30 minutes)

During your examination of the financial statements of the Gary Manufacturing Company for the year ended December 31, 1965, you find that at January 1, 1965 the Company had installed the following punched-card processing system for recording raw material purchases:

1. Vendors' invoices are sent directly to the accounts payable department by the mail department.
2. All supporting documents to the invoices are accumulated in the accounts payable department and attached to the invoices. After being checked and cash discounts computed, the invoices are accumulated in batches and adding machine tapes prepared of the net invoice amounts to provide predetermined totals. Then the batches of invoices and tapes are sent to the tabulating department.
3. In the tabulating department key punch operators prepare for each invoice an accounts payable punched card and one or more punched cards for the re-

lated debit distribution to several departmental inventories.

4. The invoice register is prepared by tab runs of the distribution cards and accounts payable cards. In this run, totals of distribution cards are compared by the tabulating machine with the amounts punched for the related accounts payable cards. Tab run subtotals by invoice batches are taken for checking to the predetermined totals.

5. The general ledger control account is posted monthly from the totals shown in the invoice register and all other journals.

6. By sorting, the distribution and accounts payable cards are separated. The distribution cards are filed for further processing. The accounts payable cards are sorted by due dates and tab runs prepared to determine cash requirements.

7. On the due dates the accounts payable cards are processed to prepare combined check and remittance statements.

8. At the end of the month the accounts payable cards in the unpaid file are tabulated for comparison with the general ledger control account.

Required:

a. List the audit procedures that you would employ in the examination of raw material purchases. In this part limit your discussion to procedures up to and including the preparation of the punched cards.

b. What audit procedures would you employ to satisfy yourself as to the reasonableness of the accounts payable balance at December 31, 1965?

Number 5 (Estimated time—20 to 25 minutes)

Part a. At the beginning of your examination of the financial statements of the Efel Insurance Company, the president of the Company requested that in the interest of efficiency you coordinate your audit procedures with the audit being conducted by the state insurance examiners for the same fiscal year. The state examiners audited the asset accounts of the Company while you audited the accounts for liabilities, stockholders' equity, income and expenses. In addition you obtained confirmations of the accounts receivable and were satisfied with the results of your audit tests. Although you had no supervisory control over the state examiners, they allowed you to review and prepare extracts from their workpapers and report. After reviewing the state examiners' workpapers and report to your complete satisfaction, you are now preparing your short-form report.

Required:

What effect, if any, would the above circumstances have on your auditor's short-form report? **Discuss.**

Part b. During your annual audit of the Cook Manufacturing Co. your assistant reports to you that although a number of entries were made during the year in the general ledger account, Notes Payable to Officers, he decided that it was not necessary to audit he account because it had a zero balance at year-end.

Required:

Do you agree with your assistant's decision? **Discuss.**

Part c. Assume that you examined the financial statements of the Nelson Company in accordance with generally accepted auditing standards and were satisfied with your findings.

Required:

Would the fact that the Company had a loan (of substantial amount to the Nelson Company) payable to a loan company of which your brother was principal stockholder have any effect on your auditor's opinion? **Discuss.**

Part d. Your son, aged 16, owns 100 shares of the 50,000 shares of the Nelson Company common stock outstanding at the balance sheet date.

Required:

Would this fact have any effect on your auditor's opinion? **Discuss.**

Number 6 (Estimated time—20 to 25 minutes)

Mr. William Green recently acquired the financial controlling interest of Importers and Wholesalers, Inc., importers and distributors of cutlery. In his review of the duties of employees Mr. Green became aware of loose practices in the signing of checks and the operation of the petty cash fund.

You have been engaged as the Company's CPA and Mr. Green's first request is that you suggest a system of sound practices for the signing of checks and the operation of the petty cash fund. Mr. Green prefers not to acquire a check-signing machine.

In addition to Mr. Green, who is the Company president, the Company has twenty employees including four corporate officers. About 200 checks are drawn each month. The petty cash fund has a working balance of about $200 and about $500 is expended by the fund each month.

Required:

Prepare a letter to Mr. Green containing your recommendations for good internal control procedures for

- **a.** Signing checks. (Mr. Green is unwilling to be drawn into routine check signing duties. Assume that you decided to recommend two signatures on each check.)
- **b.** Operation of the petty cash fund. (Where the effect of the control procedure is not evident, give the reason for the procedure.)

Number 7 (Estimated time—25 to 30 minutes)

You are engaged in the examination of the financial statements of the Ute Corp. for the year ended December 31, 1965. The following schedules for the property, plant and equipment and related allowance for depreciation accounts have been prepared by the client. You have checked the opening balances to your prior year's audit workpapers.

Ute Corp.

ANALYSIS OF PROPERTY, PLANT AND EQUIPMENT AND RELATED ALLOWANCE FOR DEPRECIATION ACCOUNTS

Year Ended December 31, 1965

ASSETS

Description	*Final 12/31/64*	*Additions*	*Retirements*	*Per Books 12/31/65*
Land	$ 22,500	$ 5,000		$ 27,500
Buildings	120,000	17,500		137,500
Machinery and equipment	385,000	40,400	$26,000	399,400
	$527,500	$62,900	$26,000	$564,400

ALLOWANCE FOR DEPRECIATION

Description	*Final 12/31/64*	*Additions**	*Retirements*	*Per Books 12/31/65*
Buildings	$ 60,000	$ 5,150		$ 65,150
Machinery and equipment	173,250	39,220		212,470
	$233,250	$44,370		$277,620

*Depreciation expense for the year.

Your examination reveals the following information:

1. All equipment is depreciated on the straight-line basis (no salvage value taken into consideration) based on the following estimated lives: buildings, 25 years; all other items, 10 years. The Company's policy is to take one-half year's depreciation on all asset acquisitions and disposals during the year.

2. On April 1 the Company entered into a ten-year lease contract for a die casting machine with annual rentals of $5,000 payable in advance every April 1. The lease is cancelable by either party (sixty days written notice is required) and there is no option to renew the lease or buy the equipment at the end of the lease. The estimated useful life of the machine is ten years with no salvage value. The Company recorded the die casting machine in the Machinery and Equipment account at $40,400, the present discounted value at the date of the lease, and $2,020, applicable to the machine, has been included in depreciation expense for the year.

3. The Company completed the construction of a wing on the plant building on June 30. The useful life of the building was not extended by this addition.

The lowest construction bid received was $17,500 the amount recorded in the Buildings account. Company personnel were used to construct the addition at a cost of $16,000 (materials, $7,500; labor, $5,500; and overhead, $3,000).

4. On August 18, $5,000 was paid for paving and fencing a portion of land owned by the Company and used as a parking lot for employees. The expenditure was charged to the Land account.

5. The amount shown in the machinery and equipment asset retirement column represents cash received on September 5 upon disposal of a machine purchased in July 1961 for $48,000. The bookkeeper recorded depreciation expense of $3,500 on this machine in 1965.

6. Crux City donated land and building appraised at $10,000 and $40,000 respectively to the Ute Corporation for a plant. On September 1, the Company began operating the plant. Since no costs were involved, the bookkeeper made no entry for the above transaction.

Required:

Prepare the formal adjusting journal entries that you would suggest at December 31, 1965 to adjust the accounts for the above transactions. Disregard income tax implications. The books have not been closed. Computations should be rounded-off to the nearest dollar.

EXAMINATION IN COMMERCIAL LAW

November 4, 1966; 8:30 a.m. to 12 m.

All questions are required.

Number 1 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the **general principles of agency law.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

An example of the manner in which the questions should be answered is shown in the following illustration:

Question

XX The following elements are necessary to constitute a pledge:
1. Possession by the pledgor.
2. Property used to secure a loan or other obligation.
3. Either real or personal property.
4. A right of redemption retained by the pledgor.
5. Title retained by the pledgor.

Answer Sheet

1. False
2. True
3. False
4. True
5. True

Questions to be Answered

A. The doctrine that a master is liable for the negligent acts of his servant
1. Is founded in the law of torts.
2. Is founded in the law of contracts.
3. Applies only if the master expressly commanded his servant to do wrong.
4. Applies only if the master commanded his servant to do wrong, either expressly or impliedly.
5. Applies only if the servant was acting in the scope of his employment and in the execution of his service.

B. A written power of attorney given by A to B
6. Is invalid unless accepted by B.
7. Expressly authorizes B to act as A's agent.
8. Expressly authorizes B to act as A's servant.
9. Impliedly creates a principal-agent relationship.
10. Vests B with apparent authority to act for A beyond the terms of the power of attorney.

C. An independent contractor
11. Can never become an agent.
12. Is a particular type of agent.
13. Usually promises a definite result.
14. Acts in a fiduciary capacity.
15. Enters into contracts in his principal's name.

D. A person is an agent when he is acting in the capacity of
16. A partner.
17. The president of a corporation.
18. An executor.
19. An auctioneer hired to conduct a public sale.
20. A lien holder.

E. If a principal intends to grant to his agent the power to enter into a contract for him and he manifests this intent only to the third party who is to contract with the agent and not to the agent,
21. The agent thereby gains "apparent" authority.
22. The agent thereby gains "real" authority.
23. The principal would not be bound to the contract so long as the agent entered it without knowing he had authority to do so.
24. If the agent later learns of his authority, accepts it and enters into the contract, he thereby acts as a factor.
25. If the agent later learns of his authority, accepts it and enters into the contract, the third party could hold the principal to the contract by invoking the doctrine of agency by estoppel.

F. If an agent makes a contract within the scope of his authority for an undisclosed principal,
26. The agent does not have "real" authority.
27. The agent does not have "apparent" authority.

28. The principal is ordinarily bound by the contract when his identity is disclosed.
29. The party contracting with the agent may elect to hold either the agent or the principal when the principal's identity is disclosed.
30. The agent is liable on the contract only until the identity of the principal is disclosed.

G. An agent acting on behalf of a known principal may not be held liable on a contract entered into with a third party on behalf of the principal, even if

31. The agent misrepresents his scope of authority.
32. The agent signs a negotiable instrument in his own name without indicating his agency.
33. The agent commits a tort in the course of discharging his duties.
34. The third party deals only with the agent and never speaks to the principal.
35. The third party mistakenly believes the principal is a wealthy man.

H. If an agent enters into an unauthorized contract with a third party on behalf of his principal,

36. The principal on learning of the act may affirm and ratify the contract although at the time the act was done the principal did not have capacity to authorize the act.
37. The principal on learning of the act may affirm and ratify the contract by remaining silent and receiving the benefits derived from the contract.
38. The principal on learning of the act may affirm and ratify the contract by suing the third party on it.
39. The third person on learning that the agent was unauthorized is entitled to withdraw from the contract only so long as the principal has not yet affirmed it.
40. The principal may not affirm the contract unless the third party agrees to allow him to do so.

I. A, a chief clerk for B, is asked by B to assume the management of his retail store while B is away on a world tour for six months. If B cannot be reached for advice, A is justified in

41. Borrowing money in B's name for the purpose of expanding the store.
42. Discharging an incompetent employee.
43. Purchasing new inventory in the regular course of trade.
44. Selling the business on receiving an excellent offer.
45. Conducting the traditional semiannual sale.

J. Circumstances which may be looked to in order to determine the intent of the principal to allow an agent to delegate his authority to a subagent include

46. The prior conduct of the parties.
47. The character of the act to be delegated.
48. The skill of the subagent.
49. The availability of the agent to do the job when it is to be done.
50. Trade practice in the industry.

K. P places an ad in the newspaper to sell his car for $1,000. A, his servant, believes the car is worth $1,500 and tells T to buy the car. A has breached his duty of loyalty to P if

51. A allowed P to sell the car to T without informing P that T was his friend.
52. A does not inform P that he believes the car is worth $1,500.
53. A accepts a payment from T for giving him the information about the car.
54. A agreed to repurchase the car from T for $1,200.
55. A misrepresented the condition of the car to P in order to induce P to sell it for a lower price.

L. A and B are adjoining land owners. A agrees to allow B six months in which to attempt to sell their properties as a joint parcel and obtain a price of at least $5,000 for A's land. B agrees to attempt to affect a sale for A on these terms.

56. B has become A's agent for the purpose of selling his land.
57. A and B are partners.
58. A and B are joint venturers.
59. B has a power coupled with an interest.
60. A may terminate his agreement with B at any time by giving notice to B.

Number 2 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the **general principles of bankruptcy law.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. D, debtor, owes $61,000 to A, $4,000 to B and $2,000 to C. D is in financial difficulty and unable to meet his debts as they mature. He offers to pay A, B and C 50 cents on the dollar in satisfaction of these debts and the parties accept this offer.

61. The parties have agreed to a composition agreement.
62. There is a lack of consideration to enforce the contract.
63. X, another unpaid creditor can attach the assets which D has set aside for satisfying A, B and C's debts.
64. D can satisfy a debt owed to Y in full without violating his agreement with A, B and C.
65. D is insolvent in the bankruptcy sense from the above facts.

B. In order for a person to be adjudged a bankrupt under the Bankruptcy Act,
66. He must owe debts totaling more than $2,000.
67. There must be at least three creditors.
68. A petition in bankruptcy must be filed by a majority of creditors.
69. The creditor must agree to the commencement of bankruptcy proceedings.
70. A petition in bankruptcy must be filed.

C. Acts of bankruptcy include a debtor
71. Making a fraudulent conveyance.
72. Intentionally making a preference.
73. Making a general assignment for the benefit of creditors.
74. Orally admitting his willingness to be adjudged a bankrupt.
75. Requesting the appointment of a receiver immediately before becoming insolvent.

D. Bankruptcy proceedings may be instituted against any person or corporation, including
76. A married woman.
77. A municipal corporation.
78. A banking corporation.
79. A building and loan corporation.
80. A partnership.

E. At the first meeting of creditors after bankruptcy proceedings have commenced,
81. A judge or referee presides.
82. Creditors may not examine the debtor unless he agrees.
83. Creditors may appoint up to four persons to act as trustees.
84. Important policy decisions must be agreed to by all creditors.
85. An attorney who represents a general creditor may be chosen to represent the trustee.

F. Duties of a bankrupt include
86. Organizing the first meeting of creditors.
87. Preparing a schedule of his property.
88. Determining which of his creditors' claims are provable.
89. Executing transfers to the trustee of his property in foreign countries.
90. Collecting and reducing his estate to money under direction of the court.

G. The trustee in bankruptcy is vested by operation of law with the bankrupt's title to all kinds of property, including
91. Patents.
92. Property transferred in fraud of creditors.
93. Exempt property.
94. Contingent remainders.
95. Interests in real property.

H. In order for a debtor to make a preference constituting an act of bankruptcy, he must, among other things, transfer property

96. While he is insolvent.
97. Within six months before the filing of a petition in bankruptcy.
98. To a creditor on account of a present debt.
99. To a creditor on account of an antecedent debt.
100. To a creditor and thereby enable him to obtain full payment of his debt.

I. If bankruptcy proceedings are instituted, a secured creditor
101. Must turn over the security he holds to the trustee in bankruptcy.
102. May waive his security, prove his claim for the full amount, and participate in sharing the debtor's assets on an equal footing with other priority creditors.
103. May satisfy the obligation owed to him from the security he holds.
104. May prove his claim as an unsecured creditor to the extent his security is inadequate.
105. May be paid in full although priority creditors may receive only part of what is due to them.

J. Classes of claims which have priority under the provisions of the Bankruptcy Act include
106. Expenses of bankruptcy administration.
107. Wages earned within one year before the date of bankruptcy.
108. Debts of less than $50.
109. Taxes.
110. Claims of creditors which are outstanding for more than three years.

K. A bankrupt can be denied a discharge in bankruptcy if
111. Creditors receive less than twenty-five cents for every dollar owed to them.
112. He fails to explain satisfactorily a deficiency in assets.
113. He refuses to obey an order or writ.
114. He negligently fails to keep adequate books of accounts.
115. He was a bankrupt before and discharged ten years ago.

L. Debts discharged by completion of bankruptcy proceedings and discharge of the debtor include
116. Contract obligations.
117. Alimony.
118. Taxes.
119. Debts incurred within one month after the bankrupt's discharge.
120. A debt arising from the commission of a willful injury.

Number 3 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered statements states a legal conclusion. You are to determine whether **each** legal conclusion is true or false according to **general principles of law** and applicable provisions of the **Uniform Commercial Code.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. The privity of warranty requirement

121. Where applicable, precludes suits for breach of warranty by buyers who have no direct contractual relationship with the manufacturer of the product purchased.
122. Has been expressly abolished.
123. Is gradually being narrowed by judicial decision and legislative action.
124. Does not apply to suits brought against the seller by the family, household, or guests of the purchaser.
125. Precludes suits for negligence by buyers who have no direct contractual relationship with the manufacturer of the product manufactured.

B. A merchant seller

126. Is deemed to give the buyer certain implied warranties of title.
127. Warrants that the title conveyed shall be good and its transfer rightful.
128. Warrants that the goods shall be delivered free of any security interest or other lien or encumbrance whether known or unknown to the buyer at the time of contracting.
129. Cannot disclaim the title warranties.
130. Warrants, as to kinds of goods that he regularly deals in, that the goods shall be delivered free of any third party's rightful claim of patent or trade mark infringement.

C. An express warranty

131. Created by an affirmation of fact or promise by the seller must be in writing to be valid.
132. Can only be created if the seller uses the words warrant or guarantee.
133. Can only be created where the seller has manifested an intention to make a warranty.
134. Can be created by a description of the goods which is made a part of the basis of the bargain.
135. Is created by the seller's affirmation of the value of his goods.

D. The warranty of merchantability

136. Cannot be disclaimed or modified.
137. Does not apply to the serving for value of food or drink to be consumed on the seller's premises.
138. Is implied in a contract of sale of goods if the seller is a merchant with respect to goods of that kind.
139. In respect to fungible goods, require that they be better than average quality within the description.
140. Implies that the goods are fit for all purposes for which such goods are used.

E. The warranty of fitness for a particular purpose

141. Cannot be created unless the buyer expressly makes known any particular purpose for which the goods are required.
142. Does not apply to goods which are purchased under a patent or trade name.
143. Is not applicable if the buyer relies on his own skill or judgment to select suitable goods.
144. Will be effectively disclaimed if the seller indicates the goods are sold "as is."
145. Will not be effectively disclaimed by language such as, "all implied warranties are hereby disclaimed."

F. A sells B 1,000 yards of carpeting at $1 a yard using a sample piece of the carpet to induce B to buy.

146. In that this is a sale by sample, the Statute of Frauds will not apply.
147. B has obtained an implied warranty that the whole of the goods will conform to the sample.
148. B cannot assert an implied warranty of merchantability.
149. B having examined the sample as fully as he desired, cannot rely upon implied warranty protection with regard to defects which he ought under the circumstances to have discovered.
150. Whatever warranties B has received, whether expressed or implied, shall be construed as consistent with each other and cumulative.

G. On January 1, S, a dealer, wrote to B: "I hereby offer to sell you the following goods (describing them) for $600. This offer will remain open for six months."

151. This offer may be withdrawn at any time before acceptance unless there is consideration for the assurance to keep the offer open.
152. This offer is irrevocable for the time stated.
153. This offer is irrevocable for only three months.
154. This offer cannot be accepted during the fourth month even though it has not been withdrawn.
155. This offer would be irrevocable for its entire duration if it were supported by consideration.

H. The Sales Article Statute of Frauds requirements

156. Apply to contracts for the sale of goods for the price of $300 or more.
157. Do not apply to the sale of choses in action.
158. May bind a merchant who receives and ignores a signed written confirmation by a fellow merchant of the sale of goods.
159. Provide that a written memorandum of sale will be insufficient if it fails to indicate the agreed quantity of goods sold.
160. Provide that a written memorandum of sale will be insufficient if it fails to indicate the price agreed upon.

I. In a "sale or return" transaction

161. Risk of loss passes to the buyer at the time the buyer manifests his final acceptance of the goods.

162. The option to return must be exercised within ten days from receipt of the goods if no time is stated.
163. The return is at the buyer's risk and expense unless otherwise agreed.
164. The goods are subject to the claims of the buyer's creditors while in the buyer's possession.
165. The buyer may return the goods even if they are wholly as warranted.

J. Risk of loss, in the absence of breach of contract,
166. Passes to the buyer at the time the contract of sale is made in respect to specific goods in a deliverable state.
167. Can be agreed upon by the parties to the contract.
168. Passes to the buyer when the seller delivers the goods to the carrier for the required delivery to a particular destination.
169. Depends upon when title to the goods passes to the buyer.
170. Remains with the seller whether or not he is required to make delivery at a particular destination so long as he retains a security interest in the goods.

K. Where conforming goods are shipped pursuant to a shipping term, risk of loss
171. Passes to the buyer upon delivery to the carrier if the term is F.O.B. the place of shipment.
172. Remains with the seller until the goods are loaded on the carrier where the term is F.O.B. railroad car, seller's place of business.
173. Passes to the buyer at the same time whether the terms are C.I.F. or C. & F.
174. Will be determined by a shipping term in the contract unless it is used in connection with the stated price and destination.
175. Cannot otherwise be allocated by the parties.

L. The seller may recover the price if
176. The goods are accepted by the buyer.
177. The goods have been lost or destroyed and risk of loss has passed to the buyer.
178. The goods are in transit and title has irrevocably passed to the buyer.
179. The seller is unable, after reasonable effort, to resell the goods identified to the contract at a reasonable price.
180. The buyer has wrongfully rejected the goods.

Number 4 (Estimated time—20 to 25 minutes)

Mrs. Jones delivered her fur jacket to Abor Company for storage. She had bought the jacket two years before and paid $1,500 for it. When the jacket was turned over to Abor Company, Mrs. Jones received a receipt which was entitled "Storage Receipt and Agreement." On the face of this paper the fur jacket was described and the following language appeared:

"At the request of the depositor and as a part of the consideration for the charge to be made to store any item described herein, Abor Company agrees to have effected for the benefit of the depositor insurance on each article

> listed in this receipt which shall, in terms usual to such insurance, cover the article against loss by fire and theft from the premises for the value set opposite each item. Storage charges are based upon the valuation herein declared by the depositor and the amount recoverable by the depositor on account of fire or theft from the premises shall not exceed such value. If a value is not declared by the depositor, each item stored shall be conclusively presumed to have a value of $25.00."

Mrs. Jones was made aware of the provisions of the receipt and did not place any value on her jacket.

Sometime after the jacket had been stored a man representing himself as a famous fashion designer called Abor Company by telephone and asked the manager if the jacket could be loaned for use in a fashion show. He promised that if this was allowed Abor Company's name would be mentioned at the show. The manager agreed to lend the coat if he could obtain Mrs. Jones' permission to do so, and it was agreed that a messenger would stop by the next day for the coat which would be loaned if Mrs. Jones agreed. The manager of Abor then called Mrs. Jones to ask her permission to have the jacket loaned for the fashion show and Mrs. Jones agreed. The coat was picked up from Abor Company by a messenger who wore a messenger's uniform and displayed credentials.

During your examination of the financial statements of Abor Company you found that the coat had never been returned. On further checking you found that the "famous fashion designer" did not exist and Abor Company is therefore unable to redeliver the jacket to Mrs. Jones.

Required:

a. Describe the relationship between Mrs. Jones and Abor Company.

b. Discuss the rights and duties which Abor Company and Mrs. Jones owed to each other.

c. Did Abor Company breach any duty it owed to Mrs. Jones? **Explain.**

d. What amount, if any, may Mrs. Jones recover against Abor Company in a suit brought by her for the loss of the jacket? **Explain.**

Number 5 (Estimated time—20 to 25 minutes)

Albert executed a contract with Blake for the construction by Blake for Albert of a factory building. At the closing of the contract, in accordance with the terms of the agreement, Albert presented Blake his signed promissory non-interest bearing demand note in the amount of $14,000, payable to bearer, as a down payment required by the contract. On the lower left corner of the note, Albert wrote "This payment arises out of a construction contract."

Two weeks later Blake took the note to Charlie, a long-time creditor, and asked him to accept the note in partial payment of a past due debt owed by Blake. Charlie read the legend on the lower left corner of the note and asked Blake if he had breached his contract with Albert. Blake said he had not and Charlie accepted this answer and took the note, although he mistrusted Blake and he knew Albert well and could have easily checked with him as to the truthfulness of Blake's statement.

Shortly after receiving the note, Charlie presented it for payment to Albert who refused to pay since, in breach of their contract, Blake had failed to begin work on Albert's job.

Required:

a. Was the instrument negotiable? **Explain.**

b. Was Charlie a "holder" of the instrument? **Explain.**

c. Was Charlie a "holder in due course" of the instrument? **Explain.**

d. If Charlie brings suit against Albert on the instrument, what decision would be rendered? **Explain.**

Number 6 (Estimated time—25 to 30 minutes)

Part a. Able and Baker are equal shareholders of the Alt Manufacturing Company, Inc. which owned a garage and storage facility that was used in its business. Title to this real property was recorded in the corporate name. Able and Baker purchased a fire insurance policy covering the building. They took out this policy in their own names, as owners rather than in the name of the Corporation and personally paid the premiums due. The face value of the policy was $40,000 and it contained the standard 80% co-insurance clause.

Filmore, an employee of the Corporation, negligently dropped his cigarette into a refuse receptacle and thereby started a fire. The building was totally destroyed as a result of the fire. Subsequently Able and Baker assigned their rights under the policy to the Corporation. The fair market value of the property was admitted by all parties to be $100,000.

The Corporation engaged a local CPA firm to examine its financial statements. During the audit a question has arisen as to how the insurance claim on the property should be treated. The Corporation asserts that on the basis of the facts, which are undisputed, the claim should be valued at the full face value of the policy, i.e., $40,000. The insurer denies all liability on the basis of (1) title being in the Corporation and not in the parties insuring and /or (2) the negligence of the Corporation's agent in causing the fire. As an alternative argument, the insurer asserts that even if it were found liable on the fire insurance policy, the amount recoverable is limited by the 80% co-insurance clause.

Required:

1. In the absence of an assignment of their rights, were Able and Baker entitled to collect on the fire insurance policy? **Explain.**

2. Does the insurer's defense of negligence on the part of the Corporation's agent preclude recovery by the Corporation? **Explain.**

3. Assume that the insurance company is liable.

   (a) How does the co-insurance clause function and what is the purpose of this clause?

(b) Will the co-insurance clause limit the amount of the Corporation's recovery? **Explain.**

4. Assume that the insurance company has satisfied a judgment obtained against it on the above claim. Will the insurance company have any rights against anyone to recover the amount paid? **Explain.**

Part b. White owns an office building which he has leased to Bac Corporation for twenty years. White and Bac both procure fire insurance on the building for their own separate protection. The building is subsequently destroyed by fire caused by the negligence of an outsider.

Required:

1. Can both White and Bac Corporation validly insure the building? **Explain.**
2. Assume that both parties can validly insure the building against loss due to fire. How will the amount of recovery be determined in such a case? **Explain.**

Number 7 (Estimated time—20 to 25 minutes)

Part a. Henry, a wealthy industrialist, bought all the outstanding stock of the Zebra Manufacturing Company from Phillips and Vogel. In deciding to purchase the stock of the Corporation and in determining the purchase price of the stock Henry relied heavily on the company's financial statements which had been examined by Charles, a CPA, who had rendered an unqualified opinion on them. At the time Charles did the audit, Henry had not approached Phillips and Vogel regarding the possible purchase of Zebra.

Several months after the sale of stock had been consummated a lawsuit for a substantial sum was brought against the Zebra Corporation. The basis for this liability was present, although contingent, at the time the audit was performed. The financial statements of the Corporation failed to disclose this contingent liability. This error was due to Charles' negligence in that he failed to make a reasonable investigation of the claim.

A valid judgment was subsequently rendered against and paid by the Corporation.

Required:

Can Henry recover from Charles the loss in value of the stock attributable to the liability? **Explain.**

Part b. The basic facts are the same as stated above in part "a" except that the financial statements in question were prepared for submission to the Securities and Exchange Commission in connection with a public offering of the Corporation's stock pursuant to the provisions of the Securities Act of 1933. James is one of the parties who bought some of the shares of stock offered to the public.

Required:

Can James recover from Charles the loss in value of the stock attributable to the liability? **Explain.**

Part c. Johnson, a CPA, was engaged by Frank & Co., a lending institution, to examine the financial statements of the Sare partnership. Frank & Co. was considering lending the Sare partnership a large amount of money. One of the partnership's current assets consisted of $25,000 face value negotiable bearer coupon bonds which were kept in the partnership's safe deposit box. Johnson, in performing the audit, went to the box and examined the bonds. Unfortunately the bonds were not genuine; instead, they were clever forgeries which only an expert could detect. This fraud was not discovered until Sare defaulted on the loan and Frank & Co. attempted to sell the bonds which had been pledged as collateral to secure the loan.

Frank & Co. asserts that Johnson is liable for the loss to the extent of the value of the bonds which if they had been genuine would have been sufficient, along with the other Sare Partnership assets, to satisfy the loan. Johnson denies liability.

Required:

Is Johnson liable for the loss? **Explain.**

Part d. Williams, a CPA, was engaged by Andrews, the president of a small corporation, to examine the corporation's financial statements. Williams was pressed for time and decided to withdraw from the engagement. Williams, without consulting Andrews told Franklin, another CPA to whom he owed a favor, to handle the client on his own behalf. Franklin was in all respects as competent as Williams. Andrews refused to accept Franklin in that he took a personal dislike to him.

Required:

Is Andrews liable for breach of contract as a result of refusing to accept Franklin? **Explain.**

Number 8 (Estimated time—25 to 30 minutes)

You have been the CPA for Arnold Smith, who has died. Mr. Smith, a widower, left surviving, his mother, age 86, and a son, Donald, age 26. Arnold Smith's daughter, Rita, died one year before his death leaving surviving her husband, Bob, and two children, Alice and Marie. At the time of Mr. Smith's death, Bob remains a widower and Alice and Marie are minors.

Mr. Smith's will, which was duly probated, provides, in part:

"All the property which I shall own at the time of my death or which shall be subject to disposition under my will is hereinafter referred to as my Residuary Estate.

"If any descendant of mine shall survive me, my Residuary Estate shall be divided and set apart for my descendants who shall survive me, in equal shares *per stirpes*. The shares so set apart shall be dealt with as hereinafter provided in this Article, and I bequeath and devise them accordingly.

"(1) In the case of each share set apart for a descendant of mine who shall be under age of twenty-five (25) years and who shall have been in being at the time of my death, my trustee shall hold such share as the principal of a separate trust for the primary benefit of such descendant, shall invest and reinvest such principal and shall pay the net income therefrom to such descendant. Such trust shall continue until such descendant shall attain the age of twenty-five (25) years or shall sooner die. Thereupon my trustee shall distribute the entire principal of such trust to such descendant, or if he shall not be living, shall distribute or otherwise deal with such principal as such descendant, by his last will duly admitted to probate and not otherwise shall direct (except that the power so granted to such descendant shall not be exercisable, to any extent, in favor of such descendant, his estate, his creditors or the creditors of his estate), and, to the extent, if any, that such principal shall not be disposed of effectively through the exercise by such descendant of the power granted to him, my trustee shall distribute such principal to the XYZ charity, a home for foster children.

"(2) In the case of each share set apart for any other descendant of mine, such share shall be distributed to such descendant.

"If no descendant of mine shall survive me, I bequeath and devise my Residuary Estate to the XYZ charity."

Mr. Smith's Residuary Estate equals $100,000. The executor and the attorney for the estate have asked you to assist in preparing financial reports for the estate.

Required:

a. Under the above terms of the will, who are the beneficiaries and what is the amount and nature of each of their legacies? **Explain.**

b. Assume that a beneficiary's share has been placed in trust under the terms of the will:

1. If the trustee believes that the beneficiary is not in need of income currently, under the above terms of the will may he accumulate income for the beneficiary so that it can be paid to the beneficiary at a later time when he is in need? **Explain.**
2. Describe the power which a beneficiary of a trust is given over the disposition of the principal of his trust.

c. Assume that a beneficiary of a trust dies before attaining the age of twenty-five years and did not effectively exercise his power under the trust so that XYZ charity becomes entitled to receive the principal of the trust. If at that time XYZ charity is no longer in existence, explain what would happen to the trust fund if the *cy pres* doctrine is applied.

d. Do the trust provisions of the will possibly violate the rules against perpetuities? **Explain.**

EXAMINATION IN THEORY OF ACCOUNTS

November 4, 1966; 1:30 p.m. to 5 p.m.

All questions are required.

Number 1 (Estimated time—25 to 30 minutes)

The following year-end financial statement was prepared by employees of the Baxter Corporation.

Baxter Corporation

STATEMENT OF FINANCIAL CONDITION

May 31, 1966

Assets

Current assets:		
Cash		$ 138,733
Marketable securities (note 1)		144,100
Trade accounts receivable, net		274,123
Trade acceptances receivable, net		11,348
Inventory		644,605
Office supplies		3,125
Total current assets		1,216,034
Property, plant, and equipment (at cost):		
Furniture and fixtures, net of $9,300 accumulated depreciation	$ 22,150	
Equipment (note 2), net of $6,420 accumulated depreciation	32,601	
Land	58,900	113,651
Total assets		$1,329,685

Liabilities and Stockholders' Equity

Current liabilities:		
Trade notes payable		$ 326,620
Trade acceptances receivable discounted		1,348
Trade accounts payable		426,530
Stock dividend payable		4,780
Total current liabilities		759,278
Long-term liabilities:		
Obligation on equipment lease (note 2)		1
Total liabilities		759,279
Contributed capital:		
Common stock, $10 par (50,000 shares authorized, 24,780 shares issued and outstanding)	$247,800	
Preferred stock, 5%, $100 par, cumulative and nonparticipating (2,000 shares authorized, 1,818 shares issued and outstanding)	181,800	
Paid-in capital from sale of common stock in excess of par	4,134	
Total contributed capital	433,734	
Retained earnings	136,672	
Total stockholders' equity		570,406
Total liabilities and stockholders' equity		$1,329,685

Notes to the Statement of Financial Condition:

1. Marketable securities are net of the $101,710 Federal income tax liability.
2. On January 5, 1966 the Corporation entered into a six-year noncancelable lease of $270,000 of equipment with a useful life of 15 years. The lease provides for rentals of $55,000 annually during the first six years and of $3,000 annually for the duration of the life of the equipment when the lease is renewed for an additional nine years.

Required:

Identify and discuss the weaknesses in presentation, disclosure, and classification in the financial statement above. Your discussion should explain why you consider them to be weaknesses and what you consider to be the proper treatment of the items. Do **not** discuss terminology or prepare a revised statement. (Assume that the arithmetic is correct.)

Number 2 (Estimated time—25 to 30 minutes)

During the examination of the financial statements of the Fendo Company, your assistant calls attention to significant costs incurred in the development of EDP programs (i.e., software) for major segments of the sales and production scheduling systems.

The EDP program development costs will benefit future periods to the extent that the systems change slowly and the program instructions are compatible with new equipment acquired at three-to-six year intervals. The service value of the EDP programs is affected almost entirely by changes in the technology of systems and EDP equipment and does not decline with the number of times the program is used. Since many system changes are minor, program instructions frequently can be modified with only minor losses in program efficiency. The frequency of such changes tends to increase with the passage of time.

Required:

a. Discuss the propriety of classifying the unamortized EDP program development costs as

1. A prepaid expense.
2. An intangible fixed asset with limited life.
3. A tangible fixed asset.

b. Numerous methods are available for amortizing assets that benefit future periods. Each method (like a model) presumes that certain conditions exist and, hence, is most appropriate under those conditions.

Discuss the propriety of amortizing the EDP program development costs with

1. The straight-line method.
2. An increasing-charge method (e.g., the annuity method).
3. A decreasing-charge method (e.g., the sum-of-the-years'-digits method).
4. A variable-charge method (e.g., the units-of-production method).

Number 3 (Estimated time—25 to 30 minutes)

After the presentation of your report on the examination of the financial statements to the board of directors of the Savage Publishing Company, one of the new directors says he is surprised the income statement assumes that an equal proportion of the revenue is earned with the publication of every issue of the Company's magazine. He feels that the "crucial event" in the process of earning revenue in the magazine business is the cash sale of the subscription. He says that he does not understand why—other than for the smoothing of income—most of the revenue cannot be "realized" in the period of the sale.

Required:

a. List the various accepted methods for recognizing revenue in the accounts and explain when the methods are appropriate. Do not limit your listing to the methods for the recognition of revenue in magazine publishing.

b. Discuss the propriety of timing the recognition of revenue in the Savage Publishing Company's accounts with

1. The cash sale of the magazine subscription.
2. The publication of the magazine every month.
3. Both events, by recognizing a portion of the revenue with cash sale of the magazine subscription and a portion of the revenue with the publication of the magazine every month.

Number 4 (Estimated time—25 to 30 minutes)

The Haag Company, your client, custom-makes components for computers. When manufacturing an order, the Company makes extra components principally to replace defective ones that customers may return within a one-year guaranty period, although orders for more of exactly the same component are received occasionally. The number of extras produced is the sum of (1) the estimated number of normal replacements, (2) an allowance for possible abnormal replacements (since the incremental cost of production is very low compared to the cost of reworking) and (3) the estimated number that can be sold after the first order. All product costs are closed to cost of goods sold when the first order is shipped, and hence the extras on hand are not assigned a value in the accounts.

Required:

a. The Haag Company classifies components to be shipped to customers as finished goods inventory.

1. Explain the meaning of the term "finished goods inventory."
2. Discuss the propriety of classifying the extra components as finished goods inventory (but defer valuation considerations to part "c.").

b. Define the term "incremental cost."

c. Assume that the Haag Company wants to classify all extra components as inventory. Discuss the propriety of carrying the extras at

1. No or nominal cost.
2. Full cost (absorption cost).
3. Incremental cost.

Number 5 (Estimated time—25 to 30 minutes)

The Cox Company, the manufacturer of a single product, operated at 80 per cent of normal capacity in 1965. Since Cox bases its overhead rate on normal capacity, the Company had a substantial amount of underapplied overhead for the period.

Early in 1966 Cox receives an order for a substantial number of units at 30 per cent off the regular $7.00 sales price. The controller wants to accept the order because $.80 of the total manufacturing cost of $5.00 per unit is fixed overhead and because the additional units can be produced within the Company's practical capacity.

The president of Cox Company wants to know if you agree with the controller.

Required:

a. Differentiate among

1. Theoretical capacity,
2. Practical capacity,
3. Normal capacity, and
4. Expected capacity.

b. Discuss the financial considerations that the president should review before accepting or rejecting the order.

c. The financial statements of Cox Company as of December 31, 1966 are likely to show overapplied overhead.

1. What is overapplied overhead?
2. What are likely to be the major causes of overapplied overhead in 1966?
3. How, if at all, should overapplied overhead be treated in the financial statements as of December 31, 1966?

Number 6 (Estimated time—25 to 30 minutes)

On January 1, 1966 Lincoln Corporation exchanged 10,000 shares of its own $20 par value common stock for 90 per cent of the capital stock of the Juilliard Company.

Required:

a. The principal limitation of consolidated financial statements is their lack of separate information about the assets, liabilities, revenues and expenses of the individual companies included in the consolidation. List the problems which the reader of consolidated financial statements encounters as a result of the limitation.

b. Depending upon the examination of the accompanying circumstances, the combination of Lincoln Corporation and Juilliard Company may be accounted for as a purchase or as pooling of interests. Discuss the differences between (1) a consolidated balance sheet prepared for a purchase and (2) a consolidated balance sheet prepared for a pooling of interests.

c. The minority interest in Juilliard Company can be presented several ways on the consolidated balance sheet. Discuss the propriety of reporting the minority interest on the consolidated balance sheet

1. As a liability.
2. As a part of stockholders' equity.
3. In a separate classification between liabilities and the equity of the Lincoln Corporation.

Number 7 (Estimated time—25 to 30 minutes)

In the course of your examination of the financial statements of the Tillich Corporation as of December 31, 1965, the following entry came to your attention:

January 4, 1965

Receivable from insurance company	$100,000	
Cash surrender value of life insurance policies....		$13,600
Retained earnings		15,900
Donated capital from life insurance proceeds		70,500
Disposition of the proceeds of the life insurance policy on Mr. Tillich's life. Mr. Tillich died on January 1, 1965.		

You are aware that Mr. Tillich, an officer-stockholder in the small manufacturing firm, insisted that the Corporation's board of directors authorize the purchase of an insurance policy to compensate for any loss of earning potential upon his death. The Corporation paid $29,500 in premiums prior to Mr. Tillich's death and was the sole beneficiary of the policy. At the date of death there had been no premium prepayment and no rebate was due. In prior years cash surrender value in the amount of $13,600 had been recorded in the accounts.

Required:

a. What is the "cash surrender value" of a life insurance policy?

b. How should the cash surrender value of a life insurance policy be classified in the financial statements while the policy is in force? **Why?**

c. Your assistant has narrowed the alternative treatments of the credit side of the entry to the three which follow. **Without** evaluating the propriety of the current operating concept of reporting income, discuss the propriety of

1. Crediting $100,000 to Retained Earnings.
2. Crediting $13,600 to Cash Surrender Value of Life Insurance Policies and $86,400 to Retained Earnings.
3. Crediting $13,600 to Cash Surrender Value of Life Insurance Policies, $15,900 to Retained Earnings, and $70,500 to Donated Capital from Life Insurance Proceeds.

Examination, May, 1967

EXAMINATION IN ACCOUNTING PRACTICE—PART I

May 17, 1967; 1:30 to 6:00 p.m.

All problems are required.

Number 1 (Estimated time—35 to 40 minutes)

Instructions

The following items pertain to the taxation of corporations.

The answers should be selected in accordance with the current *Internal Revenue Code* and *Regulations*. Select only one answer for each question. Your grade will be determined from your total score of correct answers.

An example of the manner in which the answer sheet should be marked is shown in the following illustration:

Question

XX. In 1966 Gloria Corporation had a net income of $10,000 before provision for income taxes. Included in the net income were $75 interest received on a certificate of deposit and $50 interest earned on Middletown School Bonds. Gloria Corporation's 1966 taxable income is

a. $10,000.
b. $ 9,950.
c. $ 9,925.
d. $ 9,875.
e. None of the above.

Answer Sheet

XX. b.

Items to be Answered

1. Allied Corporation's tax liability for 1966 is $73,000 before claiming an investment tax credit. In June 1966 the Corporation purchased new equipment with a useful life of ten years for $600,000. The investment tax credit allowable for 1966 is
   a. $42,000.
   b. $37,000.
   c. $29,250.
   d. $25,000.
   e. None of the above.

2. Gary Corporation had taxable income of $32,000 in 1966 computed without regard to a charitable contribution of $10,000 to a community chest. The maximum charitable contribution deduction Gary Corporation can deduct for 1966 is
   a. $9,600.
   b. $6,400.
   c. $3,200.
   d. $1,600.
   e. None of the above.

3. Packy Corporation started business July 1, 1966 and elected to amortize its organization expense of $60,000. On its 1966 calendar year tax return the maximum deduction that can be claimed for organization expense is
   a. $60,000.
   b. $12,000.
   c. $ 6,000.
   d. $ 3,000.
   e. None of the above.

4. The accumulated earnings tax imposed on corporations for improper accumulation of earnings in excess of reasonable needs does not apply to:
   a. Family-held corporations.
   b. Personal holding companies.
   c. Closely held corporations.
   d. Widely held corporations.
   e. None of the above.

5. Yule Corporation exchanged 3,000 shares of its own stock with a par value of $30,000 for a building with a fair market value of $35,000. For 1966 Yule Corporation should report
   a. A taxable gain of $5,000.
   b. A taxable gain of $2,500.
   c. No gain or loss.
   d. A taxable loss of $5,000.
   e. None of the above.

6. To elect partnership-type income taxation under the provisions of Subchapter S, the number of stockholders that a small business corporation may have cannot be more than
   a. 50.
   b. 25.
   c. 10.
   d. 5.
   e. None of the above.

7. Ezy Corporation sold 1,000 shares of its $5 par value treasury stock on September 1, 1966 for $18,000 which it had purchased on February 3, 1966 for $10,000. For 1966 Ezy Corporation should report
   a. A long-term capital gain of $13,000.
   b. A short-term capital gain of $8,000.
   c. A long-term capital gain of $8,000.
   d. Ordinary income of $8,000.
   e. None of the above.

8. Quell Corporation paid gross premiums of $400 in 1966 for a life insurance policy for the president of the Corporation. The Corporation is the beneficiary of the policy. During the year the Corporation received $100 in dividends on the policy. For 1966 Quell Corporation should claim a deduction for life insurance premiums of
   a. $400.
   b. $300.
   c. $100.
   d. —0—
   e. None of the above.

9. Stack Corporation incurred the following expenditures in 1966 in seeking a new business location:

Travel expenses	$450
Entertainment expenses	250
Meals and lodging	125
Surveyor's fees	75
Total	$900

The Corporation acquired the location in January 1967. For 1966 Stack Corporation should claim a deduction for these expenses in the amount of
   a. $900.
   b. $650.
   c. $200.
   d. $ 75.
   e. None of the above.

10. Reitz Realty Corporation, an accrual basis taxpayer, leased an apartment for five years on July 1, 1966 for a total rental of $5,000 and received the entire amount in advance. For calendar year 1966 the amount that Reitz should include in income is

a. $5,000.
b. $2,500.
c. $1,000.
d. $ 500.
e. None of the above.

11. If a corporation elects to amortize its research and experimental expenses the minimum amortization period allowable is

a. 120 months.
b. 60 months.
c. 48 months.
d. 36 months.
e. None of the above.

12. John Corporation had taxable income of $25,000 including dividend income of $5,000 received from its wholly owned domestic subsidiary, Motors Inc. For 1966 the maximum dividend received deduction that John Corporation may elect to deduct is

a. $5,000.
b. $4,250.
c. $ 200.
d. $ 100.
e. None of the above.

13. A corporation may be classified as a personal holding company when 60 per cent or more of its adjusted ordinary gross income for the tax year is considered personal holding company income and the number of individuals who directly or indirectly own 50 per cent in value of its outstanding stock is not more than

a. 50.
b. 25.
c. 10.
d. 5.
e. None of the above.

14. Brown Corporation repurchased its own bonds for $104,000 on July 5, 1966. These bonds were issued on May 5, 1951 for $100,000. For 1966 Brown Corporation should report

a. Income of $4,000.
b. Neither income nor deduction.
c. A deduction of $4,000.
d. A deduction of $2,000.
e. None of the above.

15. Telke Corporation had a $20,000 net capital loss in 1966. Telke Corporation should

a. Deduct $1,000 in 1966.
b. Deduct $20,000 in 1966.
c. Carry the loss back two years and then forward five years.
d. Carry the loss forward for three years.
e. None of the above.

16. Faye Corporation sold machinery for $12,000 on December 31, 1966. The machinery had been purchased on January 2, 1962 for $10,000. The machinery had an adjusted basis of $7,000 at date of sale. For 1966 Faye Corporation should report

a. Ordinary income of $5,000.
b. A Section 1231 gain of $5,000.
c. A Section 1231 gain of $3,000 and ordinary income of $2,000.
d. A Section 1231 gain of $2,000 and ordinary income of $3,000.
e. None of the above.

17. In 1966 Pratt Corporation acquired machinery with an expected life of 10 years for $60,000. The maximum additional first year special depreciation allowed to Pratt Corporation for 1966 is

a. $20,000.
b. $12,000.
c. $10,000.
d. $ 6,000.
e. None of the above.

18. Parent Corporation elects to file separate returns for itself and its two wholly owned subsidiaries for 1966. In order to claim multiple surtax exemptions of $25,000 for 1966, each corporation must pay a penalty tax of

a. Six per cent of total income of the unconsolidated group.
b. Six per cent on the first $25,000 of income of the corporation.
c. Two per cent on the first $25,000 of income of all corporations.
d. Two per cent of total income of the unconsolidated group.
e. None of the above.

19. Boothe Corporation had the following casualty losses during 1966. None of the losses were covered by insurance.

Loss from flood	$1,200
Goods lost in shipwreck	1,500
Collision damage to Company truck	800
Total	$3,500

For 1966 Boothe Corporation should claim a casualty loss deduction of

a. $3,500.
b. $3,400.
c. $3,200.
d. $2,700.
e. None of the above.

20. During 1966 Sino Corporation exchanged a machine with an adjusted basis of $60,000 purchased in 1963 for a similar machine with a fair market value of $64,000. In addition Sino Corporation paid $2,000 cash difference. For 1966 Sino Corporation should report

a. A Section 1231 gain of $6,000.
b. A Section 1231 gain of $2,000.
c. Ordinary income of $6,000.
d. Ordinary income of $4,000.
e. None of the above.

Number 2 (Estimated time—50 to 60 minutes)

The Good Deal Appliance Company began business on January 1, 1965. All sales of new merchandise are made on installment contracts. The Company recognizes income from the sale of new merchandise under the installment method and employs the periodic inventory system. The following information was extracted from the Company's accounts at December 31 for the years indicated:

	1966	*1965*
Installment contracts receivable:		
1965 contracts	$ 17,300	$ 42,000
1966 contracts	56,000	
Cash sales of trade-ins	20,500	
Installment sales	310,000	221,000
Purchases — new merchandise	176,700	170,180
Inventory, new merchandise — January 1	42,000	
Operating expenses	65,803	53,718
Loss from defaulted contracts	10,400	

Your audit as of December 31, 1966 disclosed the following:

1. The inventory of new and repossessed merchandise on hand at December 31, 1966 was $36,432 and $4,100 respectively.

2. When a customer defaults on a contract the Company records the repossessed merchandise at its approximate wholesale market value in a separate account. Differences between the unpaid balance on the contract and the wholesale market value are charged to the Loss from Defaulted Contracts account. Repossessed merchandise is sold on the installment contract basis.

3. The wholesale value of repossessed goods is determined as follows:

   a. Goods repossessed during year of sale are valued at 40 per cent of original sales price.

   b. Goods repossessed subsequent to the year of sale are valued at 20 per cent of original sales price.

4. There were no defaulted contracts during 1965. An analysis of contracts defaulted and charged off during 1966 follows:

	Original Sales Price	*Unpaid Contract Balance*
1965 contracts	$19,500	$10,500
1966 contracts	11,000	8,200

5. On January 1, 1966 the Company began granting allowances on merchandise traded in as part payment on new sales. During 1966 the Company granted trade-in allowances of $22,600. The wholesale value of traded-in merchandise was $15,800. All merchandise traded in during the year was sold for cash.

6. The Company uses the installment method of reporting income on goods sold on the installment basis for both book and tax purposes. Assume the income tax rate is 48 per cent.

Required:

a. 1. Prepare a schedule of unrealized gross profit at December 31, 1966 and 1965 from contract sales. Include a supporting schedule calculating the gross profit percentage for contract sales for both years.

2. Compute the adjustment (if any) that you would recommend be made to the Loss from Defaulted Contracts account.

b. Prepare a statement of income for The Good Deal Appliance Company for the year ended December 31, 1966. Supporting schedules computing the realized gross profit from (1) 1965 sales and (2) sales of traded-in merchandise should be in good form.

Number 3 (Estimated time—50 to 60 minutes)

On January 1, 1966 Prent Company purchased a controlling interest in Alec Company. The general ledger trial balances for Prent Company and Alec Company at December 31, 1966 are shown on the following page.

Prent Company and Subsidiary

GENERAL LEDGER TRIAL BALANCES

December 31, 1966

Debits	*Prent Company*	*Alec Company*
Cash	$ 37,900	$ 29,050
Marketable securities	33,000	18,000
Trade accounts receivable	210,000	88,000
Intercompany receivables	24,000	
Inventories	275,000	135,000
Machinery and equipment	518,000	279,000
Investment in Alec Company at cost	96,000	
Patents	35,000	
Cost of sales	510,000	374,000
Depreciation expense	65,600	11,200
Administrative and selling expenses	130,000	110,500
Total debits	$1,934,500	$1,044,750
Credits		
Dividends payable	$ 7,500	
Trade accounts payable	103,900	$ 96,050
Accrued expenses	91,600	78,000
Intercompany payables	8,000	
Allowance for bad debts	6,800	2,300
Accumulated depreciation	298,200	196,700
Capital stock, par value $10	150,000	
Capital stock, par value $5		22,000
Paid-in capital in excess of par value	36,000	
Paid-in capital in excess of par value		14,000
Retained earnings	370,500	
Retained earnings		102,000
Sales and services	850,000	530,000
Dividend income	4,800	
Other income	7,200	3,700
Total credits	$1,934,500	$1,044,750

The following information is also available:

1. Prent Company purchased 1,600 shares of Alec Company's outstanding stock on January 1, 1965 for $50,000 and on January 1, 1966 purchased an additional 1,400 shares for $46,000.

2. An analysis of the stockholders' equity accounts at December 31, 1965 and 1964 follows:

	Prent Company December 31 1965	Prent Company December 31 1964	Alec Company December 31 1965	Alec Company December 31 1964
Capital stock, par $10	$150,000	$150,000		
Capital stock, par $5			$ 20,000	$ 20,000
Paid-in capital in excess of par value	36,000	36,000	10,000	10,000
Retained earnings	378,000	285,000	112,000	82,000
Totals	$564,000	$471,000	$142,000	$112,000

3. Alec Company's marketable securities consist of 1,500 shares of Prent Company stock purchased on June 15, 1966 in the open market for $18,000. The securities were purchased as a temporary investment and were sold on January 15, 1967 for $25,000.

4. On December 10, 1966 Prent Company declared a cash dividend of $.50 per share payable January 10, 1967 to stockholders of record on December 20, 1966. Alec Company paid a cash dividend of $1.00 per share on June 30, 1966, and distributed a 10% stock dividend on September 30, 1966. The stock was selling for $15 per share ex-dividend on September 30, 1966. Alec Company paid no dividends in 1965.

5. Alec Company sold machinery with a book value of $4,000, and a remaining life of five years to Prent Company for $4,800 on December 31, 1966. The gain on the sale was credited to the Other Income account.

6. Alec Company includes all intercompany receivable and payable accounts in its Trade Accounts Receivable and Trade Accounts Payable accounts.

7. During 1966 the following intercompany sales were made:

	Net Sales	*Included in Purchaser's Inventory at December 31, 1966*
Prent Company to Alec Company	$ 78,000	$24,300
Alec Company to Prent Company	104,000	18,000
Totals	$182,000	$42,300

Prent Company, sells merchandise to Alec Company at cost. Alec Company sells merchandise to Prent Company at regular selling price to make a normal profit margin of 30 per cent. The market value of all inventory was in excess of cost at December 31, 1966. There were no intercompany sales in prior years.

Required:

Prepare a consolidated worksheet for Prent Company and its subsidiary, Alec Company, for the year ended December 31, 1966. The worksheet should show adjustments and eliminations, minority interest, consolidated income statement and consolidated balance sheet and should include the names of other accounts affected by adjustments or reclassifications. Formal journal entries are not necessary. Schedules of supporting computations should be in good form. Disregard tax considerations.

Number 4 (Estimated time—50 to 60 minutes)

The president of Tuttle Specialties Company requests that you prepare a statement of source and application of funds for the benefit of the stockholders. Comparative balance sheets for the Company are presented below:

Tuttle Specialties Company

GENERAL LEDGER POST-CLOSING TRIAL BALANCES

For the Years Ended December 31, 1966 and 1965

Debits	*1966*	*1965*	*Increase (Decrease)*
Cash	$ 157,700	$ 100,400	$ 57,300
Certificates of deposit due March 31, 1967	175,000		175,000
Marketable securities	100,100	262,100	(162,000)
Customers' notes and accounts receivable	390,000	327,300	62,700
Inventories	155,400	181,200	(25,800)
Investment in wholly owned subsidiary at equity in net assets	140,000	190,400	(50,400)
Bond sinking fund		62,200	(62,200)
Advance to suppliers	137,500		137,500
Plant and equipment	2,138,600	1,952,600	186,000
Goodwill		150,000	(150,000)
Discount on bonds payable		10,200	(10,200)
Total debits	$3,394,300	$3,236,400	$157,900
Credits			
Notes receivable discounted	$ 100,000		$100,000
Accounts payable	192,400	$ 147,600	44,800
Bank loans — current		70,000	(70,000)
Allowance for depreciation	510,000	359,700	150,300
Accrued payables	47,100	72,300	(25,200)
Income and other taxes payable	128,700	25,500	103,200
Deferred income taxes	58,500	65,000	(6,500)
5% mortgage bonds due 1974		320,000	(320,000)
4% serial bonds	100,000		100,000
Capital stock, $10 par value	1,110,000	900,000	210,000
Premium on capital stock	152,100		152,100
Retained earnings appropriated for the retirement of 5% mortgage bonds		62,200	(62,200)
Retained earnings unappropriated	995,500	1,214,100	(218,600)
Total credits	$3,394,300	$3,236,400	$157,900

Additional information:

1. An analysis of Retained Earnings Unappropriated account follows:

Retained earnings unappropriated, December 31, 1965		$1,214,100
Add: Net income for the year		112,200
Transfer from appropriation for retirement of 5% mortgage bonds		62,200
Total		1,388,500
Deduct: Write-off of goodwill	$150,000	
Cash dividends	90,000	
10% stock dividend	153,000	393,000
Retained earnings unappropriated, December 31, 1966		$ 995,500

2. On January 2, 1966 marketable securities costing $162,000 were sold for $165,800. The proceeds from the sale of the securities, the funds in the Bond Sinking Fund and the amount received from the sale of the 4% serial bonds were used to retire the 5% mortgage bonds at 102½.

3. The Company paid a stock dividend of 10 per cent on stock outstanding at February 1, 1966. The market value per share at that date was $17.00.

4. The Company advanced $137,500 to a supplier on August 15 for the purchase of special machinery which is to be delivered in June 1967.

5. Accounts receivable of $15,000 and $12,500 were considered uncollectible and written off against income in 1966 and 1965 respectively.

6. The stockholders approved a stock option plan on September 1, 1966. Under the plan 100,000 shares of capital stock are reserved for issuance to key employees at prices not less than market value at the dates of grant. The options will become exercisable in three equal installments starting one year after the date of grant and will expire five years after the date of grant. At December 31, 1966 options were granted for 20,000 shares at $16.00 per share. The options are carried on a memo basis and are not recorded in the accounts.

7. Extraordinary repairs of $12,500 to the equipment were charged to the Allowance for Depreciation account during the year. No assets were retired during 1966.

8. The wholly owned subsidiary reported a loss for the year of $50,400. The loss was booked by the parent.

Required:

Prepare a statement of source and application of funds and a statement of changes in working capital for year ended December 31, 1966. Supporting schedules should be in good form.

Number 5 (Estimated time—40 to 50 minutes)

Calvin Corporation commenced doing business on December 1, 1966. The Corporation uses a standard cost system in accounting for the manufacturing costs of its only product, Desex. The standard costs for a unit of Desex are:

Raw materials	10 lbs. @ $.70 per lb.	$ 7.00
Direct labor	1 hr. @ $2.00 per hr.	2.00
Overhead	100% of direct labor costs	2.00
Total		$11.00

Additional information:

1. The following data were extracted from the Corporation's books for the month of December:

	Units	*Debit*	*Credit*
Budgeted production	3,000		
Units sold	1,500		
Sales			$30,000
Sales discounts		$ 500	
Material price variance		1,500	
Material quantity variance		660	
Direct labor rate variance		250	
Manufacturing overhead budget variance			300
Purchase discounts lost		120	

The Company records purchases of raw materials net of discounts. The amounts shown above for purchase discounts lost and material price variance are applicable to raw material used in manufacturing operations during December.

2. Inventory data at December 31, 1966 indicate the following inventories were on hand:

Raw materials	None
Work-in-process	1,200 units
Finished goods	900 units

The work-in-process inventory was 100 per cent complete as to materials and 50 per cent complete as to direct labor and overhead.

Required:

a. The Corporation's policy is to allocate variances over the cost of sales and ending inventories. Prepare a schedule allocating the variances and purchase discounts lost to the ending inventories and to cost of sales. Supporting schedules should be in good form.

b. Prepare a schedule computing the cost of goods manufactured at standard cost and at actual cost for December 1966. Amounts for material, labor and overhead should be shown separately.

c. Prepare a schedule computing the actual cost of material, labor and overhead included in the work-in-process inventory and in the finished goods inventory at December 31, 1966.

EXAMINATION IN ACCOUNTING PRACTICE—PART II

May 18, 1967; 1:30 to 6:00 p.m.

GROUP I

All problems in this group are required.

Number 1 (Estimated time—40 to 50 minutes)

You were engaged by Mr. and Mrs. Roy Ward to determine their taxable income for calendar year 1966. Mr. Ward, age 56, and his wife Mary, age 53, have two children. Their daughter Jean, 18, earned $1,250 working as a file clerk and their son John, 22, a full-time student at Kirby College, earned $950 during his summer vacation. Jean and John both filed individual tax returns for the year 1966. Mr. Ward provided over half of the support of his wife and children. Mr. Ward provided you with the following data:

1. Mr. Ward received a $12,000 salary as general manager of Atez Tire, Inc. and in addition received a $1,000 expense allowance for the following travel and entertainment expenditures in connection with his employment:

Travel away from home	$900
Entertainment of customers	600

2. Mrs. Ward received $415 in fees for singing at church wedding ceremonies.

3. Mr. Ward was absent from work from February 7, 1966 to February 25, 1966 inclusive due to a back injury and was hospitalized five days during this period. Under his Company's wage continuation plan, he received his full salary during this period.

4. The following dividends and interest income were received in 1966:

Dividends:	
Tomey Corporation, New York	$ 60
Chaber Corporation, Chicago	150
Acme Savings and Loan Association, New York	50
Total	$260
Interest income:	
2% State of Ohio Bonds	$200
Kushe Corp. Bonds, New York	400
Total	$600

Mr. Ward owns the Tomey stock and Mr. and Mrs. Ward jointly own the Chaber stock. The dividends from the Acme Savings and Loan Association were for funds on deposit in their joint account. Mrs. Ward owns the bonds.

5. The Wards sold their personal residence on May 30, 1966 for $15,000, and do not intend to purchase another one. They purchased the house on July 9, 1959 for $18,000. In addition, they received $2,000 fire insurance proceeds for fire damage to their summer cottage. The cottage was purchased on April 3, 1960 for $10,000 excluding land and had a value of $6,000 before the fire and $3,200 after the fire.

6. On April 30, 1966 Mr. Ward received his first $300 monthly pension payment under his previous employer's trusteed pension fund. Mr. Ward contributed $6,000 by payroll deductions toward the cost of his pension. He will receive monthly payments for the balance of his life and these payments are expected to total $75,600.

7. Mr. and Mrs. Ward sold the following securities during 1966:

	Number of Shares	*Date Acquired*	*Date Sold*	*Cost*	*Sales Price*
Zelke Corp.	100	5/ 5/66	7/21/66	$ 900	$1,500
Kairo Corp.	200	3/ 2/64	8/12/66	6,000	3,500
Blouth Corp.	100	1/27/66	12/21/66	2,000	2,300

Mr. Ward purchased another 100 shares of Blouth stock on January 3, 1967 for $2,200. The Wards did not sell any stock in prior years.

8. The Wards' expenditures for the following items during 1966 were:

Contributions:

Salvation Army	$650
Local political campaign	25
Community Chest — 10 shares of Fedco. stock at cost (fair market value at date of gift — $200)	150

Interest:

Second Security Bank (on loan by bank to Mr. Ward's brother)	125

Medicine and drugs:

	Total	*Mr. & Mrs. Ward*	*Jean Ward*	*John Ward*
Medicine and drugs	$ 236	$147	$ 52	$ 37
Dr. Dauber, M.D.	180	160	10	10
Dr. Bergen, D.D.S.	375	250	35	90
Dr. Breeme, Chiropractor	75	75		
Hospitalization insurance	225	165	30	30
Total	$1,091	$797	$127	$167

The payment to Dr. Bergen includes an advance payment of $105 for dental services to be performed for Mrs. Ward during 1967.

Taxes and licenses:	
State income taxes	$ 185.00
State cigarette taxes	60.00
Auto license fees (car used for pleasure)	30.00
Social Security taxes withheld from wages	277.20
Federal income taxes withheld from wages	1,557.20

Required:

Prepare a schedule computing Mr. and Mrs. Ward's net income for 1966 subject to federal income taxes. Supporting schedules should be in good form.

Number 2 (Estimated time—40 to 50 minutes)

The partnership of King, Gill and Fisher engaged you to adjust its accounting records and convert them uniformly to the accrual basis in anticipation of admitting Wagner as a new partner. Some accounts are on the accrual basis and others are on the cash basis. The partnership's books were closed at December 31, 1966 by the bookkeeper who prepared the general ledger trial balance that appears below.

King, Gill and Fisher

GENERAL LEDGER TRIAL BALANCE

December 31, 1966

	Debit	*Credit*
Cash	$ 10,000	
Accounts receivable	40,000	
Inventory	26,000	
Land	9,000	
Buildings	50,000	
Allowance for depreciation of buildings		$ 2,000
Equipment	56,000	
Allowance for depreciation of equipment		6,000
Goodwill	5,000	
Accounts payable		55,000
Allowance for future inventory losses		3,000
King, capital		40,000
Gill, capital		60,000
Fisher, capital		30,000
Totals	$196,000	$196,000

Your inquiries disclosed the following:

1. The partnership was organized on January 1, 1965 with no provision in the partnership agreement for the distribution of partnership profits and losses. During 1965 profits were distributed equally among the partners. The partnership agreement was amended effective January 1, 1966 to provide for the following profit and loss ratio: King, 50%; Gill, 30%; and Fisher, 20%. The amended partnership agreement also stated that the accounting records were to be maintained on the accrual basis and that any adjustments necessary for 1965 should be allocated according to the 1965 distribution of profits.

2. The following amounts were not recorded as prepayments or accruals:

	December 31	
	1966	*1965*
Prepaid insurance	$700	$ 650
Advances from customers	200	1,100
Accrued interest expense		450

The advances from customers were recorded as sales in the year the cash was received.

3. In 1966 the Partnership recorded a provision of $3,000 for anticipated declines in inventory prices. You convinced the partners that the provision was unnecessary and should be removed from the books.

4. The Partnership charged equipment purchased for $4,400 on January 3, 1966 to expense. This equipment has an estimated life of ten years and an estimated salvage value of $400. The Partnership depreciates its capitalized equipment under the income tax declining balance method at twice the straight-line depreciation rate.

5. The partners agreed to establish an allowance for doubtful accounts at two per cent of current accounts receivable and five per cent of past due accounts. At December 31, 1965 the Partnership had $54,000 of accounts receivable, of which only $4,000 was past due. At December 31, 1966 fifteen per cent of accounts receivable was past due, of which $4,000 represented sales made in 1965, and was generally considered collectible. The Partnership had written off uncollectible accounts in the year the accounts became worthless as follows:

	Account Written Off In	
	1966	*1965*
1966 accounts	$ 800	
1965 accounts	1,000	$250

6. Goodwill was recorded on the books in 1966 and credited to the partners' capital accounts in the profit and loss ratio in recognition of an increase in the value of the business resulting from improved sales volume. The partners agreed to write off the goodwill before admitting the new partner.

Required:

a. Prepare a worksheet showing the adjustments and the **adjusted trial balance** for the partnership on the accrual basis at December 31, 1966. All adjustments affecting income should be made directly to partners' capital accounts. Number your adjusting entries. Supporting computations should be in good form. (Do not prepare formal financial statements or formal journal entries.)

b. Without prejudice to your solution to "a" above, assume the assets were properly valued and that the adjusted total of the partners' capital account balances at December 31, 1966 was $140,000 and on that date Wagner invested $55,000 in the partnership. Compute the amount of goodwill to be recorded on the partnership books under each of the following alternative agreements and allocate the goodwill to the partners:

1. Wagner is to be granted a one-fourth interest in the partnership. The other partners will retain their 50:30:20 profit and loss sharing ratio for the remaining three-fourths interest.

2. The Partnership has been earning and expects to continue to earn an annual return of 15 per cent on invested capital. The normal rate of return for comparable partnerships is 10 per cent. The expected earnings of the new partnership in excess of the normal rate of return are to be capitalized as goodwill at the rate of 20 per cent. The partners are to share profits and losses in the ratio: King, 40%; Gill, 30%; Wagner, 20%; Fisher, 10%.

Number 3 (Estimated time—50 to 60 minutes)

Niebuhr Corporation is beginning its first capital budgeting program and has retained you to assist the budget committee in the evaluation of a project to expand operations designated as Proposed Expansion Project #12 (PEP #12).

1. The following capital expenditures are under consideration:

$ 300,000	Fire sprinkler system
100,000	Landscaping
600,000	Replacement of old machines
800,000	Projects to expand operations (including PEP #12)
$1,800,000	Total

2. The Corporation requires no minimum return on the sprinkler system or the landscaping. However, it expects a minimum return of 6 per cent on all investments to replace old machinery. It also expects investments in expansion projects to yield a return that will exceed the average cost of the capital required to finance the sprinkler system and the landscaping in addition to the expansion projects.

3. Under Proposed Expansion Project #12 (PEP #12) a cash investment of $75,000 will be made one year before operations begin. The investment will be depreciated by the sum-of-the-year-digits method over a three year period and is expected to have a salvage value of $15,000. Additional financial data for PEP #12 follow:

Time Period	*Revenue*	*Variable Costs*	*Maintenance, Property Taxes, and Insurance*
0-1	$80,000	$35,000	$ 8,000
1-2	95,000	41,000	11,000
2-3	60,000	25,000	12,000

The amount of the investment recovered during each of the three years can be reinvested immediately at a rate of return approximating 15 per cent. Each year's recovery of investment, then, will have been reinvested at 15 per cent for an average of six months at the end of the year.

4. The capital structure of Niebuhr Corporation follows:

	Amount	*Percentage*
Short-term notes at 5% interest	$ 3,500,000	10%
4% cumulative preferred stock, $100 par	1,750,000	5
Common stock	12,250,000	35
Retained earnings	17,500,000	50
	$35,000,000	100%

5. Additional data available to you are summarized below:

	Current Market Price	*Expected Earnings Per Share*	*Expected Dividends Per Share*
Preferred stock, noncallable	$120	—	$4.00
Common stock	50	$3.20	1.60

The average marginal tax rate for Niebuhr stockholders is estimated to be 25 per cent.

6. Assume that the corporate income tax rate is 50 per cent.

7. The present value of $1.00 due at the end of each year and discounted at 15 per cent is:

End of Year	*Present Value*
2 years before 0	$1.32
1 year before 0	1.15
0	1.00
1 year after 0	.87
2 years after 0	.76
3 years after 0	.66

8. The present values of $1.00 earned uniformly throughout the year and discounted at 15 per cent follow:

Year	*Present Value*
0 - 1	$ .93
1 - 2	.80
2 - 3	.69

Required:

a. Assume that the cutoff rate for considering expansion projects is 15 per cent. Prepare a schedule calculating the

1. Annual cash flows from operations for PEP #12.
2. Present value of the net cash flows for PEP #12.

b. The budget committee has asked you to check the reasonableness of the cutoff rate. You realize that one of the factors to be considered is an estimate of the average cost of capital to this firm.

Prepare a schedule, supported by computations in good form, to compute the average cost of capital weighted by the percentage of the capital structure which each element represents.

c. 1. Assume that the average cost of capital computed in "b" is 9 per cent. Prepare a schedule to compute the minimum return (in dollars) required on expansion projects to cover the average cost of capital for financing the sprinkler system and the landscaping in addition to expansion projects. Assume that it is necessary to replace the old machines.

2. Assume that the minimum return computed in "c. 1" is $150,000. Calculate the cutoff rate on expansion projects.

Number 4 (Estimated time—40 to 50 minutes)

You have just commenced your audit of Shaky Company for the year ended December 31, 1966. The president advises you that the Company is insolvent and must declare bankruptcy unless a large loan can be obtained immediately. A lender who is willing to advance $450,000 to the Company has been located, but he will only make the loan subject to the following conditions:

1. A $600,000 six per cent mortgage payable on the Company's land and buildings held by a major stockholder will be cancelled along with four months' accrued interest. The mortgage will be replaced by 5,000 shares of $100 par value, six per cent, cumulative if earned, nonparticipating, preferred stock.

2. A $450,000 eight per cent mortgage payable over 15 years on the land and buildings will be given as security on the new loan.

3. On May 1, 1965 the Company's trade creditors accepted $360,000 in notes payable on demand at six per cent interest in settlement of all past-due accounts. No payment has been made to date. The Company will offer to settle these liabilities at $.75 per $1.00 owed or to replace the notes payable on demand with new notes payable for full indebtedness over five years at six per cent interest. It is estimated that $200,000 of the demand notes will be exchanged for the longer-term notes and that the balance will accept the offer of a reduced cash settlement.

4. A new issue of 500 shares of $100 par value, five per cent, noncumulative, nonparticipating, preferred stock will replace 500 outstanding shares of $100 par value, seven per cent, cumulative, participating preferred stock. Preferred stockholders will repudiate all claims to $21,000 of dividends in arrears. The Company has never formally declared the dividends.

5. A new issue of 600 shares of $50 par value, class A common stock will replace 600 outstanding shares of $100 par value, class A common stock.

6. A new issue of 650 shares of $40 par value, class B common stock will replace 650 outstanding shares of $100 par value, class B common stock.

The president of the Shaky Company requests that you determine the effect of the foregoing on the Company and furnishes the following condensed account balances, which you believe are fairly presented:

Bank overdraft	$ 15,000
Other current assets	410,000
Fixed assets	840,000
Trade accounts payable	235,000
Other current liabilities	85,000
Contributed capital in excess of par value	125,000
Retained earnings deficit	345,000

Required:

a. Prepare pro-forma journal entries that you would suggest to give effect to the foregoing as of January 1, 1967. Entries should be keyed to numbered information in order.

b. Prepare a pro-forma balance sheet for the Shaky Company at January 1, 1967 as if the recapitalization had been consummated.

GROUP II

Estimated time—50 to 60 minutes
Solve one of the two problems in this group. If both are solved, only the first will be considered.

Number 5

On June 30, 1966 James Jenkins was appointed receiver of Kivitz Mfg. Inc. The Corporation's general ledger trial balance on that date follows:

Kivitz Mfg. Inc.
GENERAL LEDGER TRIAL BALANCE
June 30, 1966

Cash	$ 14,135	
Notes receivable	29,000	
Accrued interest on notes receivable	615	
Accounts receivable	19,500	
Allowance for bad debts		$ 800
Inventories	48,000	
Stock subscriptions receivable	5,000	
Land	10,000	
Building	50,000	
Accumulated depreciation — building		15,000
Machinery and equipment	33,000	
Accumulated depreciation — machinery and equipment		19,000
Furniture and fixtures	21,000	
Accumulated depreciation — furniture and fixtures		9,500
Goodwill	8,000	
Organization cost	1,600	
Note payable to City Bank		18,000
Notes payable to Municipal Trust Company		6,000
Notes payable to vendors		24,000
Accrued interest on notes payable		1,280
Accounts payable		80,520
Wages payable		1,400
Payroll taxes payable		430
Deferred income taxes payable		25,000
Mortgage bonds payable		32,000
Accrued interest payable on mortgage bonds		1,820
Capital stock		40,000
Capital stock subscribed		5,000
Retained earnings	39,900	
Totals	$279,750	$279,750

Additional information:

1. Notes receivable of $25,000 were pledged to secure the $18,000 note payable to the City Bank. Interest of $500 was accrued on the pledged notes and $600 was accrued on the $18,000 note payable to the bank. All of the pledged notes were collectible. Of the remaining notes receivable a $1,000 noninterest-bearing note was uncollectible.

2. Accounts receivable include $7,000 from Ame Mfg. Co. Inc. which is currently being liquidated. Creditors expect to realize $.40 on the dollar. The Allowance for Bad Debts account is adequate to cover any other uncollectible accounts. A total of $3,200 of the remaining collectible accounts receivable was pledged as security for the notes payable to Municipal Trust Co. of $6,000 with accrued interest of $180 at June 30, 1966.

3. The subscriptions receivable from stockholders for no-par common stock are due July 31, 1967 and are considered fully collectible.

4. Inventories are valued at cost and are expected to realize 25 per cent of cost on a forced liquidation sale after the write-off of $10,000 of obsolete stock.

5. Land and buildings, which are appraised at 110 per cent of their book value, are mortgaged as security for the bonds. Interest of $1,820 was accrued on the bonds to June 30, 1966. The Company expects to realize 20 per cent of the cost of its machinery and equipment, and 50 per cent of cost of its furniture and fixtures after incurring refinishing expenses of $800.

6. Estimated expenses of liquidation are $4,500. Depreciation, prepaid expenses and accruals have been adjusted to June 30, 1966.

7. The Corporation has net operating loss carryovers for income tax purposes of $22,000 for 1964 plus $28,000 for 1965. Assume the tax rate in effect for those years was 50 per cent.

Required:

a. Prepare a statement of affairs classifying assets according to their availability for secured and unsecured creditors and classifying liabilities according to their legal priority and secured status. The following column headings are suggested for the statement:

For Assets:	*Book Value*	*Assets*	*Appraised Value*	*Estimated Amount Available*	*Loss or Gain on Realization*

For Liabilities and Capital:	*Book Value*	*Liabilities and Capital*	*Amount Unsecured*

b. Prepare a schedule computing the estimated settlement per dollar of unsecured liabilities.

Number 6

Your examination of the financial statements of the Town of Ecalpon for the year ended June 30, 1966 disclosed that the Town's inexperienced bookkeeper was uninformed regarding governmental accounting and recorded all transactions in the General Fund. The following General Fund trial balance was prepared by the bookkeeper:

Town of Ecalpon

GENERAL FUND TRIAL BALANCE

June 30, 1966

Cash	$ 12,900	
Accounts receivable	1,200	
Taxes receivable, current year	8,000	
Tax anticipation notes payable		$ 15,000
Appropriations		350,000
Expenditures	344,000	
Estimated revenues	290,000	
Revenues		320,000
Town property	16,100	
Bonds payable	36,000	
Unappropriated surplus		23,200
Totals	$708,200	$708,200

Your audit disclosed the following:

1. The accounts receivable balance was due from the Town's water utility for the sale of scrap iron. Accounts for the municipal water utility operated by the Town are maintained in a separate fund.

2. The total tax levy for the year was $280,000 of which $10,000 was abated during the year. The Town's tax collection experience in recent years indicates an average loss of 5 per cent of the net tax levy for uncollectible taxes.

3. On June 30, 1966 the Town retired at face value 4% General Obligation Serial Bonds totaling $30,000. The bonds were issued on July 1, 1964 in the total amount of $150,000. Interest paid during the year was also recorded in the Bonds Payable account.

4. At the beginning of the year, to service various departments the Town Council authorized a supply room with an inventory not to exceed $10,000. During the year supplies totaling $12,300 were purchased and charged to Expenditures. The physical inventory taken at June 30 disclosed that supplies totaling $8,400 were used.

5. Expenditures for 1966 included $2,600 applicable to purchase orders issued in the prior year. Outstanding purchase orders at June 30, 1966, not recorded in the accounts amounted to $4,100.

6. The amount of $8,200, due from the state for the Town's share of state gasoline taxes, was not recorded in the accounts.

7. Equipment costing $7,500 was removed from service and sold for $900 during the year and new equipment costing $17,000 purchased. These transactions were recorded in the Town Property account.

Required:

a. Prepare the formal adjusting and closing journal entries for the General Fund.

b. Prepare the formal adjusting journal entries for any other funds or groups of accounts. (The bookkeeper had recorded all transactions in the General Fund.)

EXAMINATION IN AUDITING

May 18, 1967; 8:30 a.m. to 12:00 m.

GROUP I

All questions in this group are required.

Number 1 (Estimated time—20 to 25 minutes)

You are engaged in your first audit of the Licitra Pest Control Company for the year ended December 31, 1966. The Company began doing business in January 1966 and provides pest control services for industrial enterprises.

Additional information:

1. The office staff consists of a bookkeeper, a typist and the president, Tony Licitra. In addition, the Company employs twenty servicemen on an hourly basis who are assigned to individual territories to make both monthly and emergency visits to customers' premises. The servicemen submit weekly time reports which include the customer's name and the time devoted to each customer. Time charges for emergency visits are shown separately from regular monthly visits on the report.

2. Customers are required to sign annual contracts which are prenumbered and prepared in duplicate. The original is filed in numerical order by contract anniversary date and the copy is given to the customer. The contract entitles the customer to pest control services once each month. Emergency visits are billed separately.

3. Fees for monthly services are payable in advance—quarterly, semi-annually or annually—and are recorded on the books as "income from services" when the cash is received. All payments are by checks received by mail.

4. Prenumbered invoices for contract renewals are prepared in triplicate from information in the contract file. The original invoice is sent to the customer twenty days prior to the due date of payment, the duplicate copy is filed chronologically by due date, and the triplicate copy is filed alphabetically by customer. If payment is not received by fifteen days after the due date, a cancellation notice is sent to the customer and a copy of the notice is attached to the customer's contract. The bookkeeper notifies the servicemen of all contract cancellations and reinstatements and requires written acknowledgment of receipt of such notices. Mr. Licitra approves all cancellations and reinstatements of contracts.

5. Prenumbered invoices for emergency services are prepared weekly from information shown on servicemen's time reports. The customer is billed at 200 per cent of the serviceman's hourly rate. These invoices, prepared in triplicate and distributed as shown above, are recorded on the books as "income from services" at the billing date. Payment is due 30 days after the invoice date.

6. All remittances are received by the typist, who prepares a daily list of collections and stamps a restrictive endorsement on the checks. A copy of the list is forwarded with the checks to the bookkeeper, who posts the date and amount received on the copies of the invoice in both the alphabetical and chronological files. After posting, the copy of the invoice is transferred from the chronological file to the daily cash receipts binder, which serves as a subsidiary record for the cash receipts book. The bookkeeper totals the amounts of all remittances received, posts this total to the cash receipts book and attaches the daily remittance tapes to the paid invoices in the daily cash receipts binder.

7. The bookkeeper prepares a daily bank deposit slip and compares the total with the total amount shown on the daily remittance tapes. All remittances are deposited in the bank the day they are received. (Cash receipts from sources other than services need not be considered.)

8. Financial statements are prepared on the accrual basis.

Required:

a. List the audit procedures you would employ in the examination of the Income from Services account for 1966.

b. You are considering using the services of a reputable outside mailing service for the confirmation of accounts receivable balances. The service would prepare and mail the confirmation requests and remove the returned confirmations from the envelopes and give them directly to you.

What reliance, if any, could you place on the services of the outside mailing service? **Discuss** and state the reasons in support of your answer.

Number 2 (Estimated time—25 to 30 minutes)

You have completed your audit of Carter Corporation and its consolidated subsidiaries for the year ended December 31, 1966 and were satisfied with the results of your examination. You have examined the financial statements of Carter Corporation for the past three years. The Corporation is now preparing its annual report to shareholders. The report will include the consolidated financial statements of Carter Corporation and its subsidiaries and your short-form auditor's report. During your audit the following matters came to your attention:

1. The Internal Revenue Service is currently examining the Corporation's 1964 federal income tax return and is questioning the amount of a deduction claimed by the Corporation's domestic subsidiary for a loss sustained in 1964. The examination is still in process and any additional tax liability is indeterminable

at this time. The Corporation's tax counsel believes that there will be no substantial additional tax liability.

2. A vice president who is also a stockholder resigned on December 31, 1966 after an argument with the president. The vice president is soliciting proxies from stockholders and expects to obtain sufficient proxies to gain control of the board of directors so that a new president will be appointed. The president plans to have a footnote prepared which would include information of the pending proxy fight, management's accomplishments over the years, and an appeal by management for the support of stockholders.

3. In 1966 the Corporation changed its method of accounting for the investment credit. An investment credit of $121,000 deferred in prior years was credited to retained earnings and the full 1966 investment credit of $50,000 was recorded as a reduction of income tax expense. As a result net income after taxes for 1966 was increased by $45,000. You approved of this change as an acceptable alternative accounting treatment.

Required:

a. 1. Prepare the footnotes, if any, that you would suggest for the items listed above.

2. State your reasons for not making disclosure by footnote for each of the listed items for which you did not prepare a footnote.

b. Assume that your recommended footnotes are adopted. In addition assume that on January 2, 1966 Carter Corporation acquired a 60 per cent interest in Adler Company for $275,000. The investment is reported in Carter Corporation's balance sheet at December 31, 1966 as follows: "Investment in Unconsolidated Subsidiary, at cost—$275,000." The net assets of Adler Company at December 31, 1966 were $600,000 and the Company had net income of $96,000 for the year. No dividends were received from Adler Company in 1966. The president insists that no footnote be prepared relating to the investment in the unconsolidated subsidiary since the investment basis (cost) is shown on the financial statements. Prepare a partial short-form auditor's report of your examination. (Omit the scope paragraph; prepare only the middle paragraph, if any, and the opinion paragraph.)

Number 3 (Estimated time—25 to 30 minutes)

You are now conducting your third annual audit of the financial statements of Elite Corporation for the year ended December 31, 1966. You decide to employ unrestricted random number statistical sampling techniques in testing the effectiveness of the Company's internal control procedures relating to sales invoices, which are all serially numbered. In prior years, after selecting one representative two-week period during the year, you tested all invoices issued during that period and resolved all of the errors which were found to your satisfaction.

Required:

a. Explain the statistical procedures you would use to determine the size of the sample of sales invoices to be examined.

b. Once the sample size has been determined, how would you select the individual invoices to be included in the sample? **Explain.**

c. Would the use of statistical sampling procedures improve the examination of sales invoices as compared with the selection procedure used in prior years? **Discuss.**

d. Assume that the Company issued 50,000 sales invoices during the year and the auditor specified a confidence level of 95 per cent with a precision range of plus or minus 2 per cent.

1. Does this mean that the auditor would be willing to accept the reliability of the sales invoice data if errors are found on no more than four sales invoices out of every ninety-five invoices examined? **Discuss.**

2. If the auditor specified a precision range of plus or minus 1 per cent, would the confidence level be higher or lower than 95 per cent assuming that the size of the sample remains constant? **Why?**

Number 4 (Estimated time—25 to 30 minutes)

Part a. During 1966 your client, Nuesel Corporation, requested that you conduct a feasibility study to advise management of the best way the Corporation can utilize electronic data processing equipment and which computer, if any, best meets the Corporation's requirements. You are technically competent in this area and accept the engagement. Upon completion of your study the Corporation accepts your suggestions and installs the computer and related equipment that you recommended.

Required:

1. Discuss the effect the acceptance of this management services engagement would have upon your independence in expressing an opinion on the financial statements of the Nuesel Corporation.

2. Instead of accepting the engagement, assume that you recommended Ike Mackey, of the CPA firm of Brown and Mackey, who is qualified in specialized services. Upon completion of the engagement your client requests that Mackey's partner, John Brown, perform services in other areas. Should Brown accept the engagement? **Discuss.**

3. A local printer of data processing forms customarily offers a commission for recommending him as supplier. The client is aware of the commission offer and suggests that Mackey accept it. Would it be proper for Mackey to accept the commission with the client's approval? **Discuss.**

Part b. Your CPA firm decides to form a partnership with Fred Reitz, a non-

CPA management consultant, which would result in a "mixed partnership" of a CPA and a non-CPA.

Required:

Under what circumstances, if any, would it be ethically proper for a CPA to form a "mixed partnership?" **Discuss.**

Part c. Alex Pratt, a retired partner of your CPA firm, has just been appointed to the board of directors of Palmer Corporation, your firm's client. Pratt is also a member of your firm's income tax committee which meets monthly to discuss income tax problems of the partnership's clients. The partnership pays Pratt $100 for each committee meeting he attends and a monthly retirement benefit of $1,000.

Required:

Discuss the effect of Pratt's appointment to the board of directors of Palmer Corporation on your partnership's independence in expressing an opinion on the Palmer Corporation's financial statements.

Number 5 (Estimated time—25 to 30 minutes)

On April 6, 1967 fire completely destroyed the warehouse and all books and records of the Kramer Corporation, a wholesaler of office stationery. Kramer Corporation had a fire insurance policy on the inventory (in addition to insurance policies on other assets) which did not require the Corporation to file a monthly inventory report. The Ecker Insurance Company retained you to audit the statement of the actual cash value of the inventory fire loss of $265,000 reported by Kramer Corporation.

The Corporation began doing business on January 1, 1966 and the financial statements for 1966 were audited by the Corporation's certified public accountant, who rendered an unqualified opinion. The CPA also prepared the Corporation's income tax return for 1966 and, with the president's permission, has granted you access to his copy of the tax return as well as to his workpapers relating to Kramer Corporation.

Required:

a. List the audit procedures you would apply to verify the amount of the inventory fire loss on April 6, 1967 claimed by the assured.

b. Assume that you are satisfied with the results of your examination and you are now preparing your report.

1. Which, if any, of the generally accepted auditing standards pertaining to reporting would apply to this report? **Discuss.**

2. Describe the topics relating to your examination to which you should refer in your report.

Number 6 (Estimated time—25 to 30 minutes)

You are engaged in your fifth annual examination of the financial statements of Stack Corporation. Your examination is for the year ended December 31, 1966. The client prepared the following schedules of Trade Notes Receivable and Interest Receivable for you at December 31, 1966. You have checked the opening balances to your prior year's audit workpapers.

Your examination reveals the following information:

1. Interest is computed on a 360-day basis. In computing interest, it is the Corporation's practice to exclude the first day of the note's term and to include the due date.

2. The Atkins Company's 90-day note was discounted on May 16 at 6 per cent and the proceeds were credited to the Trade Notes Receivable account. The note was paid at maturity.

3. Forster Industries became a bankrupt on August 31 and the Corporation will recover seventy-five cents on the dollar. The Corporation uses the direct write-off method for recording bad debt expense. All of Stack Corporation's notes receivable provide for interest at the legal rate of 6 per cent on the maturity value of a dishonored note.

4. J. Stack, president of Stack Corporation, confirmed that he owed the Corporation $10,000 and that he expected to pay the note within six months. You are satisfied that the note is collectible.

5. Listi Corporation's 60-day note was discounted on November 1 at 6 per cent and the proceeds were credited to the Trade Notes Receivable and Interest Receivable accounts. On December 2 Stack Corporation received notice from the bank that Listi Corporation's note was not paid at maturity and that it had been charged against Stack's checking account by the bank. Upon receiving the notice from the bank the bookkeeper recorded the note and accrued interest thereon in the Trade Notes Receivable and Interest Receivable accounts. Listi Corporation paid Stack Corporation the full amount due in January 1967.

6. The Holshue Inc. 90-day note was pledged as collateral for $35,000, 60-day, 6 per cent loan from the First National Bank on December 1.

7. On November 1 the Corporation received four $6,000 90-day notes from Simpson Co. On December 1 the Corporation received payment from Simpson Co. for one of the $6,000 notes with accrued interest. Prepayment of the notes is allowed without penalty. The bookkeeper credited Simpson Co. Accounts Receivable account for the cash received.

Required:

Prepare the adjusting journal entries that you would suggest at December 31, 1966 for the above transactions. (Disregard income tax implications.)

Stack Corporation

TRADE NOTES RECEIVABLE AND RELATED INTEREST RECEIVABLE

TRADE NOTES RECEIVABLE

Maker	Issue Date	Terms	Interest Rate	Balance December 31, 1965	1966 Debits	1966 Credits	Balance December 31, 1966
Brehm Company	4/1/65	One year	6%	$60,000		$ 60,000	
Atkins Company	5/1/66	90 days after date	—		$ 20,000	19,750	$ 250
Forster Industries	7/1/66	60 days after date	6%		4,000		4,000
J. Stack	8/3/66	Demand	6%		10,000		10,000
Listi Corporation	10/2/66	60 days after date	6%		40,000	40,000	
					40,000		40,000
Holshue Inc.	11/1/66	90 days after date	3%		42,000	35,000	7,000
Simpson Co.	11/1/66	90 days after date	6%		24,000		24,000
Totals				$60,000	$180,000	$154,750	$85,250

INTEREST RECEIVABLE

Due From	Balance December 31, 1965	1966 Debits	1966 Credits	Balance December 31, 1966
Brehm Company	$2,700	$ 900	$3,600	
Forster Industries		40		$ 40
J. Stack		200		200
Listi Corporation		400	198	202
Holshue Inc.		210		210
Simpson Co.		240		240
Totals	$2,700	$1,990	$3,798	$892

GROUP II

Estimated time—25 to 35 minutes

Answer one of the two questions in this group.

If both are answered only the first will be considered.

Number 7

When auditing an electronic data processing system the CPA must be aware of the different types of controls built into the equipment. The controls built into the equipment fall into two groups: those incorporated by the user in his program, and those built into the equipment by the manufacturer.

Required:

a. Why are accuracy checks on system components or peripheral equipment necessary?

b. Define and give the purpose of each of the following program checks and controls:

1. Record counts.
2. Limit check.
3. Reverse multiplication.
4. Sequence check.
5. Hash totals.

c. Most electronic data processing equipment manufacturers have built-in checks to ensure that information is correctly read, processed, transferred within the system and recorded. One of these built-in checks is the parity bit.

1. What is the parity bit?
2. When would the parity bit control be used?

d. When computers are used the CPA has to be familiar with the information stored on paper tape reels, magnetic tape reels, etc. A common form of magnetic tape record retention employs the grandfather-father-son principle.

1. Define the grandfather-father-son principle.
2. Why are grandfather-father-son tapes usually stored at different locations?

Number 8

During your audit of the Pientak Corporation for 1966 you find that the Corporation plans to install the following purchase order draft system for paying vendors:

1. The Corporation will issue a draft in the form of a blank check attached to the purchase order for purchases. The purchase order draft (POD) form will

combine a purchase order (upper half of form) with a blank check (lower half of form) and the two documents will be prenumbered with the same number and perforated so that the check can be easily detached.

2. The purchasing department will be responsible for the issuance and the PODs will be valid for a period of ninety days from the date of issuance. Each of eight buyers will maintain a suply of PODs. The supply will be replenished as needed.

3. The cashier's department will maintain a log of the numbers of the PODs given to each buyer. Unissued PODs will be kept in a safe in the cashier's office. The POD form will consist of five parts, which will be distributed as follows:

a. Copy #1 will be the purchase order and will be mailed to the vendor.
b. Copy #2 will be sent to the receiving department.
c. Copy #3 will be sent to the bookkeeping department.
d. Copy #4 will be filed numerically in the purchasing department.
e. Copy #5 will be kept by the buyer for follow-up purposes.

4. When the purchase order is issued, the buyer will enter the quantity, unit price, extended amount, and the total estimated amount of the order on the upper half of the POD form. The check will be made out in the vendor's name, dated and signed by the buyer. The original of the five-part form will then be mailed to the vendor.

5. The vendor will enter his invoice number, quantity, unit price and total amount of goods to be shipped in the space provided on the check. When the goods are shipped the vendor will enter the total amount of the shipment on the face of the check and present the completed check to the bank for payment. No partially filled orders will be accepted. Vendors who deliver a quantity less than that ordered must receive a new purchase order for additional quantities to be delivered.

6. The bank will honor the check if it has not matured, stamp it "Paid" and charge the amount to the Corporation's general cash account. The bank will send the paid checks to the cashier's department daily. After reviewing the paid checks the cashier's department will prepare an adding machine tape of the amounts and enter the total each day in the cash disbursement journal, debiting Accounts Payable. The paid checks will then be sent to the purchasing department.

7. When the goods are received, the receiving department will compare the quantity of items received to copy #2 of the POD, indicate the date the goods are received, initial copy #2 and route it to the purchasing department. The purchasing department will match the receiving department's copy #2 with the paid POD received from the cashier's department and enter the account distribution on the description section of the check. The extensions of unit prices multiplied by quantities entered by the vendor will be checked and the receiving department's copy #2 attached to the paid check and the documents sent to the bookkeeping department.

8. The bookkeeping department will charge the appropriate asset or expense accounts at the time the paid checks are recorded in the accounts payable register. The checks, together with the related receiving reports, will then be filed by vendor.

Required:

a. The treasurer of the Corporation requests your aid in preparing a memorandum informing the bank of the new "POD" procedures. List the instructions that you would recommend be given to the bank regarding the POD bank account and the payment of "POD" checks.

b. The internal control procedures within the Corporation with regard to purchases in general are excellent. Suggest additional internal control measures needed for the use of purchase order drafts and verification of paid and unpaid PODs.

EXAMINATION IN COMMERCIAL LAW

May 19, 1967; 8:30 a.m. to 12 m.

All questions are required.

Number 1 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the **Uniform Partnership Act.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

An example of the manner in which the question should be marked is shown in the following illustration:

Question

XX. The following elements are necessary to constitute a pledge:
1. Possession by the pledgor.
2. Property used to secure a loan or other obligation.
3. Either real or personal property.
4. A right of redemption retained by the pledgor.
5. Title retained by the pledgor.

Answer Sheet

XX.
1. False
2. True
3. False
4. True
5. True

Questions to be Answered

You are the CPA retained by Smith, Charles and Black who are in business together.

A. Smith, Charles and Black share profits and consider themselves partners. However, they are not actually members of a partnership until
   1. A certificate of doing business as a partnership is signed and filed.
   2. They agree to the duration of the partnership.
   3. A partnership office is formally opened in the state.
   4. A partnership agreement is signed.
   5. An income tax return is filed for the partnership.

B. If Smith, Charles and Black are partners
   6. Each is the agent of the other.
   7. Each is the agent of the partnership.
   8. Each is personally liable on contracts made for the partnership which are within the scope of the partnership business.
   9. Each partner has implied authority to confess a judgment where a sum of money is due and owing by the partnership without consulting the other partners.
   10. Each partner has implied authority to execute a general assignment for the benefit of creditors where it is warranted without consulting the other partners.

C. If the partners have made no agreement to the contrary
   11. A majority vote of the partners may control decisions connected with the ordinary partnership business.
   12. All partners have equal rights in the management and conduct of the business regardless of the amount of experience or talent each may have.
   13. No partner is entitled to receive interest on monies lent by him to the partnership.
   14. Each partner must contribute to losses according to his share of profits.
   15. Profits will be divided in proportion to the amount of each partner's capital investment in the partnership.

D. The accounting records of the partnership
   16. Should be kept at the principal place of business of the partnership unless otherwise agreed.
   17. Are open to inspection by any former partner at any time as an absolute right.
   18. Belong to the partner keeping the records.
   19. Are admissible in evidence against the interests of the partnership.
   20. Are closed to a former partner after his withdrawal from the partnership under all circumstances.

E. If a new partner is to be admitted to the firm
   21. All present partners must agree that he is to be admitted.
   22. The old partnership is dissolved.

23. The old partnership must be wound up and liquidated.
24. The new partner is not liable in any manner for any pre-existing obligations of the partnership.
25. The new partner is liable for pre-existing obligations of the partnership to the same extent as the other partners.

F. The requisite capacity to join the partnership is possessed by
26. Another partnership.
27. A minor.
28. A trustee.
29. An estate.
30. An insolvent person.

G. If a partnership agreement provides that the partnership is to remain in force for a definite term
31. The partnership cannot be dissolved before the expiration of that term.
32. The partnership may only be dissolved by the unanimous consent of all of the partners.
33. The death of any partner dissolves the partnership.
34. Any partner has the power to dissolve the partnership at any time.
35. Repudiation of the partnership by a partner before the end of the stipulated term may subject the partner to an action for breach of contract.

H. If the partners decided to incorporate
36. The partners would immediately upon dissolution of the partnership and incorporation have limited liability for all outstanding debts.
37. The parties may be personally liable after incorporation to creditors who continue to deal with them without knowledge of their incorporation.
38. A creditor may be held to have notice of the dissolution of a partnership from surrounding circumstances even if not told directly.
39. Notice to all creditors of dissolution is generally deemed sufficient if given by publication.
40. Sufficiency of a published notice to creditors will vary depending on whether a creditor has dealt with the partnership in the past.

I. Upon the death of a partner
41. The partnership is dissolved even if its term has not expired.
42. The deceased partner's representative has a legal interest in the assets of the partnership.
43. The deceased partner's representative has an equitable interest in the distribution of any surplus funds remaining after payment of firm debts.
44. The deceased partner's representative does not have the right to demand an accounting.
45. The rights and duties of the deceased's partner's personal representative may be governed by a partnership agreement.

J. Upon the death of a partner
46. His estate is liable as long as the deceased partner's name is continued to be used in the firm name.
47. The right to use the deceased partner's name is part of the goodwill of the firm.
48. The firm name passes to the surviving partners if they purchase and continue the business.
49. Provision cannot be made in a partnership agreement for sale of the name upon the death of the partner.
50. A court is powerless to enjoin the misuse of a deceased partner's name.

K. In settling accounts between partners and creditors upon dissolution, among the items to be paid prior to satisfying the general creditors are
51. Debts of creditors entitled to a preference.
52. Debts owing to partners on account of loans made to the partnership.
53. Amounts owing to partners in respect of capital investments.
54. Debts of secured creditors which remain after exhausting any available security.
55. Back salaries due to partners.

L. The partnership is to be liquidated. Smith has contributed $6,000 to capital; Charles $3,000 to capital; and Black has made no contribution to capital but has merely contributed his services. Liabilities of the partnership exceed assets by $9,000. The following contributions must be made by the partners from their personal assets if there is no prior agreement on sharing losses:
56. Smith need not make a contribution.
57. Smith must contribute $3,000.
58. Charles must contribute $3,000.
59. Black must contribute $6,000.
60. Black must contribute $3,000.

Number 2 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to **general principles of suretyship law and the provisions of Article 9 (Secured Transactions) of the Uniform Commercial Code.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. A person who is planning to make a loan to an individual may lawfully ask, as a condition to obtaining the loan, that the individual
61. Pledge personal property having a value far in excess of the amount

of the loan in order to provide the creditor with security.
62. Execute a negotiable promissory note for the amount of the loan.
63. Agree to overstate the amount of the loan in order to permit the interest rate to appear to be allowable under the usury law.
64. Procure a certified public accountant's report which does not fairly present the financial condition of the individual.
65. Obtain another person's promise to answer for his debt.

B. A suretyship relationship
66. May be a two party transaction.
67. Is usually founded on a contract.
68. Requires a written offer and acceptance.
69. Requires a formal contract among all of the parties.
70. May arise by operation of law.

C. A surety
71. Does not have a right to reimbursement for a greater amount than he has paid.
72. May seek exoneration before satisfying any of the outstanding obligations.
73. May assert his right to contribution against the creditor after the creditor has been paid.
74. May become subrogated to the rights of the creditor after the creditor has been paid.
75. Must assert all available *bona fide* defenses of which he is aware in a suit brought by the creditor, if he is going to recover subsequently in an action for reimbursement against the principal debtor.

D. A surety may successfully assert as a defense against the creditor who sues him
76. The death of the principal debtor.
77. The insolvency of the principal debtor.
78. A private agreement affecting the surety's liability made by the principal debtor and the surety.
79. The nondisclosure by the creditor of facts which materially increase the surety's risk.
80. A substantial modification of the principal debtor's obligation which is not agreed to by the surety.

E. If a surety has agreed to be responsible for the debt of the principal debtor under a conditional guarantee
81. The creditor can immediately sue the surety upon the maturity of the obligation.
82. The creditor must join the principal debtor in a suit brought against the surety.
83. The creditor can institute an action against the surety once he has commenced an action against the principal debtor.
84. The creditor must first exhaust all of the legal remedies he has against the principal debtor before he can sue the surety.
85. The creditor may lose his rights against the surety if he delays suing the principal debtor.

F. The provisions of the Uniform Commercial Code dealing with secured transactions replace the following statutes in force in the jurisdictions adopting the Code.

86. Uniform Conditional Sales Act.
87. Chattel Mortgage Act.
88. Factor's Lien Act.
89. Uniform Trust Receipts Act.
90. Retail Installment Sales Act.

G. The Uniform Commercial Code

91. Adopts a single lien theory.
92. Does not distinguish between a possessory and a nonpossessory security interest.
93. Abolishes many distinctions based upon historical development and form.
94. Emphasizes the importance of who holds title to goods.
95. Narrows the availability of the different types of property which may serve as security.

H. The Uniform Commercial Code governs a creditor's obtaining a security interest in

96. Real estate.
97. Inventory.
98. Fixtures.
99. After-acquired property.
100. Chattel paper.

I. A security interest in goods may be created under the Uniform Commercial Code by a creditor's

101. Obtaining an oral agreement under which he takes possession of the security.
102. Obtaining an unsigned written security agreement.
103. Obtaining a security agreement signed only by the debtor.
104. Filing a financing statement which is not in itself a security agreement.
105. Obtaining the debtor's written promise to execute a security agreement on demand of the creditor.

J. If a creditor is able to perfect a security interest in goods, his security interest

106. Assures him that his debt will be repaid.
107. May have been perfected by possession.
108. Entitles him to a position ahead of all other creditors.
109. Has priority over all statutory liens.
110. Will be entitled to the greatest protection available under the Uniform Commercial Code.

K. The Uniform Commercial Code classifies personal property into groupings which include

111. Consumer goods.

112. Business goods.
113. Equipment.
114. Hard goods.
115. Soft goods.

L. If Adams sells a refrigerator to Baker on credit and obtains a proper security agreement so that the refrigerator may serve as collateral for the payment of the amount due
116. Adams may perfect his interest in the refrigerator by filing a financing statement which evidences the existence of a security agreement.
117. Adams has a "purchase money" security interest.
118. If Adams files a financing statement within 10 days after he delivers the refrigerator to Baker, Adams' security interest will take priority over the rights of a lien creditor whose lien arose during that time.
119. If Adams fails to file a financing statement, Adams' security interest will not be effective if Baker sells the refrigerator to his next door neighbor who buys it in good faith.
120. If Adams fails to file a financing statement, Adams' security interest will not be effective if Baker sells the refrigerator to a second hand dealer who buys it in good faith.

Number 3 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the **provisions of Article 3 (Commercial Paper) of the Uniform Commercial Code.** Write on the separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. In respect to drafts
121. The drawer and payee may be the same person.
122. The drawee is primarily liable at the time of issue.
123. The drawer is secondarily liable at the time of issue.
124. A draft must be payable on demand in order to be negotiable.
125. The check is the most common type of draft.

B. The trade acceptance

126. Must be signed by the drawer and drawee in order to be negotiable.
127. Is normally used in conjunction with a title document and the trade acceptance is forwarded through banking channels for acceptance or payment by the buyer.
128. Imposes no liability upon the buyer prior to acceptance.
129. May be either a sight or time draft.
130. Must be accepted by the acceptor's signing before a notary and the acceptor's acknowledgment must be taken.

C. The certificate of deposit

131. Is an acknowledgment by a bank of receipt of money with a promise to repay.
132. Is typically payable on demand.
133. Is payable to order by use of the words "payable upon return of this instrument properly indorsed."
134. Is the same as a cashier's check.
135. May contain the printed signature of the appropriate bank official in lieu of his actual signature.

D. An instrument is a bearer instrument if it is payable

136. To the order of an imposter.
137. To the order of bearer.
138. To cash.
139. To the order of a named person and indorsed in blank.
140. To bearer initially and the last indorsement is a special indorsement.

E. A promise or order, otherwise unconditional, is not made conditional by the fact that the instrument

141. Contains a provision indicating the instrument is subject to a certain contractual agreement.
142. Is limited to payment out of a particular fund and is issued by a governmental agency.
143. Is limited to payment out of the entire assets of a partnership.
144. States that it is secured by a mortgage.
145. States that the instrument matures "as per" the transaction out of which it arose.

F. The sum payable is certain even though it is to be paid

146. With the cost of collection upon default.
147. With attorney's fees upon default.
148. With a stated addition to the face amount if paid after maturity.
149. By stated installments with interest.
150. With the current rate of exchange added to the face amount.

G. An instrument is payable at a definite time if by its terms it is payable

151. At the end of a period of time after a stated date.

152. Upon the happening of an event which is uncertain as to the time of occurrence.
153. At a definite time subject to an option in the hands of the holder to extend the time.
154. One year after the date of death of the maker.
155. At a definite time but subject to acceleration.

H. A person (other than the payee) in possession of an instrument is a *holder* (as distinguished from a mere possessor, transferee, or assignee) if he acquired ownership by
156. An indorsement which purports to transfer less than the full face amount of the instrument.
157. Mere delivery of a bearer instrument.
158. Delivery for value of an order instrument which is not indorsed.
159. Finding a bearer instrument in the street.
160. Delivery of an order instrument along with a separate detached indorsement in blank by the transferee.

I. An indorsement is restrictive if it
161. Is conditional.
162. States that it prohibits further negotiation.
163. Indicates it is "without recourse" to the indorser.
164. Includes the words "pay any bank or banker."
165. Includes the words "for deposit to my account."

J. A restrictive indorsement
166. Limits the indorser's liability in respect to warranties given to the transferee.
167. Prevents further negotiation of the instrument.
168. Prevents all subsequent parties from becoming holders in due course of the instrument.
169. Does not put intermediary banks on notice nor otherwise affect their rights as a result of the restrictive indorsement.
170. Imposes upon the indorser's depository bank the obligation to pay or apply any value given it consistent with the indorsement.

K. An unindorsed order instrument was duly delivered to Milton. He will be considered
171. A holder of the instrument if at the time he received it he took it in good faith.
172. A mere transferee.
173. To have obtained all the rights of his prior transferor if he took it in good faith.
174. A holder in due course, irrespective of good faith, upon obtaining the prior party's signature.
175. A holder, if he subsequently obtains the proper indorsement of his transferor.

L. A holder in due course takes the instrument free from
176. All claims of ownership to it by any person.
177. The defense of infancy even if local law makes it a defense to a simple contract.
178. Discharge in bankruptcy.
179. Fraud in the execution.
180. The illegality of the underlying transaction such as would render the obligation a nullity.

Number 4 (Estimated time—20 to 25 minutes)

Wingate hired Stanford as his full-time assistant to review and analyze the financial aspects of Wingate's prospective real estate investments. Stanford's hiring came after working with Wingate on similar projects on a part-time basis for several years and resulted because of Wingate's being well satisfied with Stanford's work and experience in the field.

The lengthy employment agreement prepared by Wingate's attorney and signed by the parties provides that employment is to terminate after three years unless the contract is renewed. It also provides, in part:

> "It is distinctly understood and agreed that the services to be rendered by Stanford hereunder must meet Wingate's approval, and Wingate shall be sole judge as to the adequacy of the services. If at any time Wingate is in any way dissatisfied with any of the services, he is free to terminate the services."

Stanford, who left an excellent position to accept employment with Wingate, had not read the clause in the contract set out above. He was, therefore, shocked when two months after starting his new job Wingate referred to the contract clause and requested Stanford to leave his employ. Stanford has commenced a suit for damages against Wingate, alleging breach of the contract.

Required:

a. 1. Explain the doctrine of mutuality of obligation.
   2. Did this doctrine exist between the parties to the contract? **Explain.**

b. Was the contract clause allowing Wingate to terminate the agreement effective even though Stanford did not read it? **Explain.**

c. If a contract existed and the contract clause allowing Wingate to terminate the agreement was effective, would Wingate be liable for breach of contract if a jury found:

1. That Wingate was not in fact dissatisfied with Stanford's services but that the real motivation for firing Stanford was Wingate's plan to retire from business and he, therefore, no longer required Stanford's help. **Explain.**

2. That Wingate was dissatisfied with some of the conclusions Stanford reached but that any reasonable man would disagree with Wingate and find Stanford's work proper and satisfactory. **Explain.**

Number 5 (Estimated time—20 to 25 minutes)

Hershey, an accountant, performed professional services for Martin for several years without receiving any compensation. Hershey pressed Martin for payment. Martin explained that at the moment he was unable to pay Hershey in cash. However, as payment he offered to deed to Hershey part of his property which he had purchased in an isolated area in another state many years before. Hershey and Martin agreed that Hershey should take a trip to inspect the property before deciding whether or not Hershey would agree to Martin's offer. Expecting that Hershey would accept the property once he saw it, Martin drew and signed a deed for the property and asked Hershey to hold the deed for the property conditionally until his return. Hershey visited the property and found that Ahrens had moved on to the property several years before and that Ahrens considered it his own. Hershey also discovered that Saffer, who bought a strip of adjacent land from Martin, has for a long time regularly crossed the property to visit his land.

Hershey returned home still unsure of whether or not he should accept Martin's proposition. On arrival, however, Hershey learned that Martin had died insolvent and, fearing the loss of his fee, Hershey produced the deed and announced to the executor of the estate that he considered the property his own. Martin's executor questions Hershey's title.

Required:

a. As between Hershey and the executor of Martin's estate, who is entitled to the land? **Explain.**

b. Under what theory might Ahrens claim title to the land? What facts would Ahrens have to show to claim title to the land?

c. Under what theory or theories might Saffer claim the right to cross the land? What facts would Saffer have to prove in order to claim an interest in the land?

Number 6 (Estimated time—20 to 25 minutes)

You are the accountant for the Ajax Washing Machine Company. The Company installs and operates coin metered washing machines in the basements of apartment houses for the use and convenience of the tenants in the building. While auditing the records of Ajax, you found the following:

Ajax recently entered into an agreement with the owner of a building under which the building owner granted Ajax permission to install and maintain a coin metered washing machine for a period of three years from the date of installation. Ajax retains ownership of the machine and is to keep all proceeds derived from its use, paying the owner a fixed monthly amount for the privilege of having the machine in the building. The agreement further provides that the building owner will furnish Ajax space which the owner chooses and the power required for the operation of the machine. In addition, the owner agrees that he will allow Ajax to enter the building to service the machine.

Recently the building owner sold his property to a new owner who has disconnected the machine and who refuses to comply with the agreement which, he alleges, is not binding on him.

Required:

a. List and describe the essential elements required for a lease.

b. List and describe the essential elements required for a license.

c. Did the agreement between the parties create a lease or a license? **Explain.**

d. Must the new owner of the building honor the agreement entered into between the former owner and Ajax? **Explain.**

e. If the agreement had been called a "Lease" and if Ajax had been referred to as the "Tenant" and the former owner as the "Landlord," would your answer to "d" change? **Explain.**

Number 7 (Estimated time—30 to 35 minutes)

You have been engaged to examine the financial statements of Endo Corporation for the year ended December 31, 1966. The Corporation is closely held although there are distinct minority groups of preferred and common shareholders. Its stock is not listed on any stock exchange. Your audit of the Corporation's books and records reveals the following situations.

Part a. The Endo Corporation was duly incorporated in the State of Y in 1960. During all years prior to the current year its operations and activities were all of an intrastate nature taking place in State Y. In 1966, however, a sales office was established in State Z and two resident salesmen authorized to contact prospective customers in that state, to solicit orders and to make sales. The Corporation has taken no action in respect to the Secretary of State of Z nor the administrative agency which administers the State of Z's corporation laws.

Required:

What is the danger that this set of facts raises in respect to the Endo Corporation? **Discuss.** Indicate the possible penalties or liabilities that may be asserted in light of the facts.

Part b. A dissident group of noncumulative 6% preferred shareholders learned that during certain recent years in which they were shareholders (some still own the shares), and in which the Endo Corporation failed to pay the 6% preferred dividend despite adequate earnings, the Corporation's directors were quietly buying in the preferred stock at 80% of the $100 par value at which the shares were originally issued and sold.

Required:

The dissident preferred shareholders seek to have the directors declare a dividend to cover all prior and current year's dividends. Will they prevail? **Discuss.**

Part c. A well-organized minority group of common shareholders have asserted that the Endo Corporation's directors and officers have been guilty of mismanagement and negligence and have allowed the corporate assets to be shamefully wasted. They demand to see the books and records of the Endo Corporation in order to obtain all the relevant facts. Furthermore they demand to be permitted to make copies of the lists of shareholders. They also demand that they be permitted to bring in their attorney and their accountant.

Required:

1. What is the standard of care which a director or officer should exercise in respect to managing corporate affairs? **Discuss.**

2. Do the shareholders have the right (1) to examine the books, (2) make copies of the lists of stockholders and (3) bring along their attorney and their accountant? **Discuss.**

3. Suppose the Corporation refuses to permit any inspection of the books, records or lists. What recourse do the shareholders have? **Discuss.**

Part d. During 1966 the Endo Corporation sold a block of newly authorized shares of common stock via a private placement. An examination of the charter and the stock certificates reveals that nothing is expressly provided for regarding the existing shareholders' preemptive right.

Required:

What problem, if any, does this set of facts generate for the Corporation? **Discuss.**

Part e. Doe, who has sharply criticized the management of other corporations, purchased 1,000 shares of Endo Corporation stock. The transfer agent, upon the instructions of the officers of the Corporation, refused to transfer the shares on the books of the Corporation or issue a stock certificate to the purchaser.

Required:

What are the legal implications created by these facts? **Discuss.**

Number 8 (Estimated time—20 to 25 minutes)

Part a. Ozgood purchased a used automobile from Superior Auto Sales Corporation. Unfortunately the car was defective. In order to put the car in adequate running condition Ozgood had to replace the clutch and have a complete overhaul of the motor. The car was only one year old and appeared to be in good condition at the time of purchase. The salesman orally assured Ozgood that the car was an excellent buy and in "good shape." Ozgood offered to have the car examined by his mechanic, but the salesman assured him this would not be necessary.

Ozgood demanded that Superior Auto Sales Corporation repair the auto but they refused. He, therefore, took it to several authorized dealers and, after several bids on the repair job, selected the low bid. This amounted to $625. He now seeks to recover that amount based upon breach of warranty.

Superior Auto Sales relies upon the following disclaimer clause:

"All warranties express and implied are hereby disclaimed."

This appeared on the back of the form along with a large number of standardized provisions which were all in very small type.

Required:

1. What warranties are created as a result of the above fact situation?

2. Will the disclaimer clause effectively preclude Ozgood from recovery of the $625? **Discuss.**

Part b. Fan Motor Company purchased a motor from the Excello Motor Manufacturing Company. The contract contained several written express warranties followed by a written description of the motor purchased and a disclaimer clause. It stated in the description that the motor had a kilowatt capacity of 650. This kilowatt capacity was very important to Fan Motor. It turned out that the motor had a kilowatt capacity of less than 600 which rendered the motor worthless for Fan Motor's use.

Fan Motor seeks to rescind the transaction. Excello refuses, stating that the motor meets all the requirements contained in the express warranties, which is true. Excello admits that the motor did not meet the 650 kilowatt capacity but asserts that this was merely a part of the description and not an express warranty. Furthermore, the disclaimer clause admittedly effectively precludes any reliance upon implied warranty protection.

Required:

As between Fan Motor and Excello, who will prevail? **Explain.**

Part c. Martha purchased a can of Pure Best Quality Company's beef stew from the corner grocer. This was served to her maid at the luncheon meal. One hour later the maid developed an acute case of ptomaine poisoning.

The maid is seeking to recover damages against the corner grocer who asserts that he has no liability to her in that she was not the purchaser of the contaminated stew.

Required:

Can the maid sue and recover from the corner grocer? **Discuss.**

EXAMINATION IN THEORY OF ACCOUNTS

May 19, 1967; 1:30 p.m. to 5 p.m.

All questions are required.

Number 1 (Estimated time—25 to 30 minutes)

Although "substantial authoritative support" can exist for accounting principles that differ from Opinions of the Accounting Principles Board, Opinions of the Accounting Principles Board are one form of "substantial authoritative support."

Basing your answers on the **Opinions of the Accounting Principles Board and the Accounting Research Bulletins as revised or continued in force,** select the best answer choice for each of the following items. Select only one answer for each item.

An example of the manner in which the answer sheet should be marked is shown in the following illustration:

Item

XX. Opinions of the Accounting Principles Board apply only to items that are
   a. Immaterial.
   b. Material and significant
   c. In excess of ten percent of net income.
   d. In excess of twenty percent of net income.

Answer Sheet

XX. b.

Items to be Answered

1. Which of the following is a current asset?
   a. Cash surrender value of a life insurance policy of which the company is the beneficiary.
   b. Investment in marketable securities for the purpose of controlling the issuing company.
   c. Cash designated for the purchase of tangible fixed assets.
   d. Trade installment receivables normally collectible in 18 months.

2. The basis for classifying assets as current or noncurrent is the period of time normally required by the accounting entity to convert cash invested in
   a. Inventory back into cash, or 12 months, whichever is shorter.
   b. Receivables back into cash, or 12 months, whichever is longer.
   c. Tangible fixed assets back into cash, or 12 months, whichever is longer.
   d. Inventory back into cash, or 12 months, whichever is longer.

3. In no case can "market" in the lower-of-cost-or-market rule be more than
   a. Estimated selling price in the ordinary course of business.
   b. Estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal.
   c. Estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal and an allowance for an approximately normal profit margin.
   d. Estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal, an allowance for an approximately normal profit margin, and an adequate reserve for possible future losses.

4. Past-service benefit costs incurred upon the adoption of a pension plan should be charged to
   a. The current period.
   b. Retained earnings.
   c. Current and future periods benefited.
   d. Future periods benefited.

5. Gains on sales of treasury stock should be credited to
   a. Additional paid-in capital.
   b. Capital stock.
   c. Retained earnings.
   d. Other income.

6. Dividends paid from the pre-acquisition earnings of a subsidiary should be treated as
   a. An addition to the retained earnings of the parent.
   b. An addition to capital in excess of par value.
   c. Other income of the parent.
   d. A reduction of the parent's investment in the subsidiary.

7. As a minimum, how large in relation to total outstanding shares may a stock distribution be before it should be accounted for as a stock split instead of as a stock dividend?
   a. No less than 2% to 5%.
   b. No less than 10% to 15%.
   c. No less than 20% to 25%.
   d. No less than 45% to 50%.

8. Which one of the following types of losses is excluded from the determination of net income in income statements?
   a. Material losses resulting from transactions in the company's own capital stock.
   b. Material losses resulting from unusual sales of assets not acquired for resale.
   c. Material losses resulting from the write-off of intangibles.
   d. Material losses resulting from adjustments specifically related to operations of prior years.

9. Which of the following is **not** an acceptable treatment of the excess of the unamortized discount on bonds refunded over the reduction of current income taxes attributable to the refunding?
   a. A direct charge to retained earnings.
   b. A direct charge to paid-in capital.
   c. Amortization over the remaining years of the original life of the bonds refunded, or over the new issue if its life terminates before the original life of the old issue.
   d. Amortization over the life of the new issue.

10. How should unearned discounts, finance charges and interest included in the face amount of installment receivables be presented in the balance sheet?
   a. As a current liability.
   b. As a deferred credit.
   c. As a deduction from the related receivable.
   d. Within the stated amount of the receivable.

11. How should "cumulative preferred dividends not earned" be treated in computing the loss per share of common stock?
   a. Deducted from the loss for the year.
   b. Added to the loss for the year.
   c. Deducted from income in the year paid.
   d. Added to income in the year paid.

12. Which of the following accounts in a foreign subsidiary's trial balance may **not** be converted to domestic currency in terms of the current rate of exchange?
   a. Sales.
   b. Intercompany accounts payable incurred during the year.
   c. Long-term liabilities incurred several years ago.
   d. Long-term receivables obtained several years ago.

13. The issuer of a 5% common stock dividend to common stockholders preferably should transfer from retained earnings to contributed capital an amount equal to the
   a. Market value of the shares issued.
   b. Book value of the shares issued.
   c. Minimum legal requirement.
   d. Par or stated value of the shares issued.

14. When the following periods are different, the preferable treatment of real and personal property taxes is monthly accrual over the
   a. Fiscal period of the taxpayer.
   b. Fiscal period of the taxing authority.
   c. Year beginning on the assessment date.
   d. Year ending with the assessment date.

15. For which of the following purposes should a reserve for indefinite possible future losses on inventory be established?
   a. To match current revenues with applicable costs.
   b. To reduce fluctuations in net income in order to lend stability to the company.
   c. To charge operations in periods of rising prices for the losses which may otherwise be absorbed in periods of falling prices.
   d. To inform stockholders that a portion of retained earnings should be set aside from amounts available for dividends because of such a contingency.

16. Which of the following intangible assets should be amortized?
   a. Copyrights.
   b. Organization costs with unlimited life.
   c. Perpetual franchises.
   d. Trademarks.

17. Depreciation on appraisal increments in the value of property, plant and equipment should be
   a. Ignored because the increments have not been paid for and should not be matched with revenue.
   b. Charged to an appropriation of retained earnings equal to the unamortized amount of the appraisal increment.
   c. Charged to income.
   d. Charged to additional paid-in capital.

18. When work to be done and costs to be incurred on a long-term contract can be estimated dependably, which of the following methods of revenue recognition is preferable?
   a. Sales method.
   b. Installment method.
   c. Percentage of completion method.
   d. Completed contract method.

19. Which of the following contingencies need **not** be disclosed in the financial statements or the notes thereto?
   a. Pending litigation.
   b. Possibility of a strike.
   c. Possible assessments of additional taxes.
   d. Notes receivable discounted.

20. Which of the following concepts of "funds" is preferable for statements of sources and applications of funds prepared for presentation in annual reports?

a. Current assets.
b. Net working capital.
c. Net income plus depreciation.
d. All financial resources.

Number 2 (Estimated time—25 to 30 minutes)

The financial statements of the Shinn Corporation recognize profits on installment sales in the period during which the merchandise is shipped. The profits on such sales, however, are reported in the corporate income tax returns on the installment basis.

Under this tax reporting method the Corporation will defer for tax purposes $10,000 of profits on $50,000 of accounts receivable at year end. All related expenses will be reported in the financial statements and in the federal income tax return. The Corporation plans to carry $4,800 as a liability for federal income taxes to be paid in future years.

Required:

a. Interperiod tax allocation is necessary because there are differences in the timing of revenues and expenses between financial statements and federal income tax returns. List the categories of circumstances that result in such timing differences and give examples of them.

b. Explain the following interperiod tax allocation concepts.
1. Liability concept.
2. Deferred concept.
3. Net of tax concept.

c. The propriety of applying the liability concept to deferred taxes on installment sales is questioned sometimes because no legal debtor-creditor relationship underlies the "liability for federal income taxes to be paid in future years."

Write a rebuttal to this argument.

Number 3 (Estimated time—25 to 30 minutes)

The Roz Corporation, a client, is considering the authorization of a 5 per cent common stock dividend to common stockholders. The financial vice president of the Corporation wishes to discuss the accounting implications of such an authorization with you before the next meeting of the board of directors.

Required:

a. The first topic he wishes to discuss is the nature of the stock dividend to the recipient.
1. Discuss the case **for** considering the stock dividend as income to the recipient.
2. Discuss the case **against** considering the stock dividend as income to the recipient.

b. The other topic for discussion is the propriety of issuing the stock dividend to all "stockholders of record" or to "stockholders of record exclusive of shares held in the name of the Corporation as treasury stock."

1. Discuss the case **for** issuing stock dividends on treasury shares.
2. Discuss the case **against** issuing stock dividends on treasury shares.

c. These topics raise several issues about the nature of the accounting entity and the equities for which it is accountable. Of the theories which explain accounting equities, describe the

1. Proprietary theory.
2. Entity theory.
3. Residual equity theory.
4. Fund theory.

Number 4 (Estimated time—25 to 30 minutes)

The controller of the Robinson Company is discussing a comment you made in the course of presenting your audit report.

". . . and frankly," Mr. Fisher continued, "I agree that we, too, are responsible for finding ways to produce more relevant financial statements which are as reliable as the ones we now produce.

"For example, suppose the Company acquired a finished item for inventory for $40 when the general price-level index was 110. And, later, the item was sold for $75 when the general price-level index was 121 and the current replacement cost was $54. We could calculate a 'holding gain.' "

Required:

a. Explain to what extent and how current replacement costs already are used **within** generally accepted accounting principles to value inventories.

b. Calculate in good form the amount of the holding gain in Mr. Fisher's example.

c. Why is the use of current replacement cost for **both** inventories and cost of goods sold preferred by some accounting authorities to the generally accepted use of FIFO or LIFO?

d. Why do some authorities believe that the present market resale (exit or output) price is a conceptual improvement upon current replacement (entry or input) cost for inventory measurement?

Number 5 (Estimated time—25 to 30 minutes)

The Harbison Company manufactures two sizes of plate glass which are produced simultaneously in the same manufacturing process. Since the small sheets of plate glass are cut from large sheets which have flaws in them, the joint costs are allocated equally to each good sheet, large and small, produced. The difference in after-split-off costs for large and small sheets is material.

In 1966 the Company decided to increase its efforts to sell the large sheets because they produced a larger gross margin than the small sheets. Accordingly the amount of the fixed advertising budget devoted to large sheets was increased and the amount devoted to small sheets was decreased. However, no changes in sales prices were made.

By midyear the production scheduling department had increased the monthly production of large sheets in order to stay above the minimum inventory level. However, it also had cut back the monthly production of small sheets because the inventory ceiling had been reached.

At the end of 1966 the net result of the change in product mix was a decrease of $112,000 in gross margin. Although sales of large sheets had increased 34,500 units, sales of small sheets had decreased 40,200 units.

Required:

a. Distinguish between joint costs and

1. After-split-off costs.
2. Fixed costs.
3. Prime costs.
4. Indirect costs.

b. Discuss the propriety of allocating joint costs for general purpose financial statements on the basis of

1. Physical measures, such as weights or units.
2. Relative sales or market value.

c. In the development of weights for allocating joint costs to joint products, why is the relative sales value of each joint product usually reduced by its after-split-off costs.

d. Identify the mistake that the Harbison Company made in deciding to change its product mix and explain why it caused a smaller gross margin for 1966.

Number 6 (Estimated time—25 to 30 minutes)

Lessors engage in leasing activities for diverse reasons.

Required:

a. What factors should a lessor consider in choosing a method of assigning revenues and expenses to lease periods?

b. For what types of leasing activities should lessors utilize the

1. Financing method?
2. Operating (or rental) method?

c. Under the operating method lessors report gross rentals as revenue over the life of the lease.

1. How should the investment be classified?
2. What should be disclosed?

Number 7 (Estimated time—25 to 30 minutes)

The Bosley Company, a medium-sized manufacturer, has been experiencing losses for the five years that it has been doing business. Although the operations for the year just ended resulted in a loss, several important changes resulted in a profitable fourth quarter and the future operations of the Company are expected to be profitable.

The treasurer suggests that there be a quasi-reorganization to (1) eliminate the accumulated deficit of $423,620, (2) write up the $493,100 cost of operating land and buildings to their fair value and (3) set up an asset of $203,337 representing the estimated future tax benefit of the losses accumulated to date.

Required:

a. What are the characteristics of a quasi-reorganization? That is, of what does it consist?

b. List the conditions under which a quasi-reorganization generally would be justified.

c. Discuss the propriety of the treasurer's proposals to

1. Eliminate the deficit of $423,620.
2. Write up the value of the operating land and buildings $493,100 to their fair value.
3. Set up an asset of $203,337 representing the future tax benefit of the losses accumulated to date.

EXAMINATION IN ACCOUNTING PRACTICE—PART I

November 1, 1967; 1:30 to 6:00 p.m.

GROUP I

Solve all problems in this group.

Number 1 (Estimated time—35 to 45 minutes)

Instructions

The following items pertain to the taxation of individuals and estates.

On a separate answer sheet write the letter of your answer choice for each of the following questions. The answers should be selected in accordance with the *Internal Revenue Code* and *Tax Regulations* in effect for 1967. Select only one answer for each question.

An example of the manner in which the questions should be marked is shown in the following illustration:

Question

XX. John Doe is 25 years old, unmarried, has good sight, and did not contribute to the support of any other person in 1967. He is entitled to a deduction for personal exemption of

a. $1,800.
b. $1,200.
c. $ 600.
d. $ -0-
e. None of the above.

Answer Sheet

XX. c.

Questions to be Answered

1. On May 1, 1967, Lloyd Dever sold his summer home for $10,000 from which he paid a broker a $1,000 sales commission. He had purchased this house in 1960 for $6,000. On June 2, 1967, he purchased another summer home for $12,000. Mr. Dever customarily occupies his summer home for approximately four months during the year. For 1967 Mr. Dever would report a
   a. Long-term capital gain of $4,000.
   b. Short-term capital gain of $4,000.
   c. Long-term capital gain of $3,000.
   d. Short-term capital gain of $3,000.
   e. None of the above.

2. Jack Grace provided the sole support of his wife and their four small children. He earned $7,200 in 1967 and had allowable itemized deductions totaling $650. The Graces' joint income tax return should show a taxable income of
   a. $3,000.
   b. $2,950.
   c. $2,880.
   d. $2,800.
   e. None of the above.

3. Mrs. Jelsen, a widow, earned $7,000 in 1967 and paid $800 to a housekeeper who spent 40 per cent of her time doing household chores and 60 per cent of her time caring for Mrs. Jelsen's two children, who were 11 and 15. If she itemizes her deductions, Mrs. Jelsen is entitled to claim child care expenses of
   a. $800.
   b. $700.
   c. $480.
   d. $240.
   e. None of the above.

4. James Johnson, who is 19 and single, earned $2,400 working in a grocery store during 1967. In addition he won $300 in a poker game and lost $250 in another poker game. His adjusted gross income for 1967 is
   a. $2,700.
   b. $2,450.
   c. $2,400.
   d. $2,150.
   e. None of the above.

5. Without incurring any gift tax liability, a husband who has never made a prior gift may in one year give his wife gifts with a fair market value of
   a. $66,000.
   b. $33,000.
   c. $30,000.
   d. $ 3,000.
   e. None of the above.

6. Jack Shriver inherited certain securities which cost his father $5,000 and which he had offered to buy from his father for $6,800 shortly before his father's death. The securities had fair market values of $7,000 at the date of death and $7,200 at the date they were distributed to Shriver. An estate tax return was not required to be filed. The tax basis of the securities to Jack Shriver is

a. $7,200.
b. $7,000.
c. $6,800.
d. $5,000.
e. None of the above.

7. In January 1967, Al Brinskle, a South Carolina resident, accepted a position in Oregon with a new employer by whom he is still employed. His new employer paid him a $1,500 moving expense allowance which Mr. Brinskle applied to the following expenses incurred in moving to Oregon:

$ 200—Plane fare for himself.
$ 400—Bus fare for Mrs. Brinskle and children.
$1,100—Cost of moving household effects.
$ 150—Meals and lodging for Mrs. Brinskle and children during trip.

For 1967 Mr. Brinskle included the $1,500 moving expense allowance in his income. In computing his adjusted gross income he is permitted to deduct

a. $1,850.
b. $1,700.
c. $1,300.
d. $ 600.
e. None of the above.

8. Joe Goddard was assessed a deficiency on his 1962 federal income tax return; the additional tax was $100 plus a penalty of $25 and interest of $36. Goddard paid the $161 in 1967. If he itemizes his deductions on his 1967 return, this $161 payment will allow him to claim a deduction of

a. $161.
b. $ 61.
c. $ 36.
d. $ 25.
e. None of the above.

9. John Zola purchased 100 shares of Ecker Corporation $1.00 par value common stock on January 25, 1967, for $6,000. On June 27 he received a stock dividend of ten shares of Ecker Corporation $100 par value preferred stock when the market values per share of the preferred and common stock were $150 and $75 respectively. Zola's tax basis for the common stock after the receipt of the stock dividend is

a. $6,000.
b. $5,000.
c. $4,500.
d. $2,000.
e. None of the above.

10. Albert Gill purchased a single-life annuity contract on himself at a cost of $13,500. The contract specified that he would receive $100 per month for life upon reaching age 65 on January 1, 1967. The annuity table provides a life multiple of 15 for a male, aged 65. Of the $1,200 received in 1967, the amount Gill can exclude from his adjusted gross income is

a. $1,200.
b. $1,080.
c. $ 900.
d. $ 300.
e. None of the above.

11. James Alford completed construction of a new building on June 17, 1966, at a total cost of $30,000 on land which had cost him $5,000 and opened his office as a lawyer on July 1, 1966. His practice grew rapidly and he leased larger facilities and moved his offices on January 1, 1967. On his 1966 tax return he claimed depreciation for a half year in the amount of $1,000 computed under the double-declining balance method for a thirty-year useful life. On January 14, 1967, Alford sold the land and building for $35,000 of which $5,000 was allocable to the land. This sale, subject to Section 1250, will result in ordinary income for 1967 in the amount of

a. $1,000.
b. $ 970.
c. $ 940.
d. $ 500.
e. None of the above.

12. Mrs. Quinn, a widow, elected to receive the proceeds of a $40,000 face-value insurance policy on the life of her husband in ten annual installments of $5,300 each beginning in 1967. Of the $5,300 received in 1967, the amount subject to income tax is

a. $5,300.
b. $4,000.
c. $1,300.
d. $ 300.
e. None of the above.

13. John Frank, unmarried and a school teacher, had the following income during 1967:

Wages from Public School System	$6,000
Dividends from Teachers Credit Union	$ 125
Unemployment insurance benefits	$ 660
Interest on State of Ohio bonds	$ 140

For 1967 John Frank would report an adjusted gross income of

a. $6,925.
b. $6,785.
c. $6,025.
d. $6,000.
e. None of the above.

14. An estate with two beneficiaries is entitled to claim a deduction in lieu of a personal exemption of

a. $1,200.
b. $ 600.
c. $ 300.
d. $ 100.
e. None of the above.

15. Joe McCarthy received a gift of stock from his father who had purchased the stock for $2,000 in 1964. The stock had a fair market value of $2,600 on February 1, 1967, the date of the gift. Gift taxes of $200 were paid. The tax basis for determining gain on the sale of these stocks is

a. $2,800.
b. $2,600.
c. $2,200.
d. $2,000.
e. None of the above.

16. Frank Maxwell, who is single, purchased a new machine for use in his business on January 1, 1967 at a cost of $15,000. The machine has a useful life of ten years and an estimated salvage value of $2,000. Assuming he purchased no other depreciable assets in 1967, the maximum depreciation that Maxwell can claim is

a. $4,600.
b. $3,000.
c. $2,600.
d. $1,300.
e. None of the above.

17. On July 7, 1967 Robert Harris exchanged a tract of land (purchased for $10,000 in 1960 and held for investment) for another similar tract of land worth $15,000. He also received $3,000 in cash on the exchange. The tax basis of the new tract of land is

a. $18,000.
b. $15,000.
c. $13,000.
d. $12,000.
e. None of the above.

18. Refer to number "17" above. In 1967, if Harris has no other capital gain or loss transactions, he will report a long-term capital gain of

a. $8,000.
b. $5,000.
c. $4,000.
d. $2,500.
e. None of the above.

19. Jack Boyd exchanged land held more than six months as an investment with a tax basis of $18,000 for similar land worth $20,000 owned by Ralph Jackson. In connection with this transaction, Boyd assumed Jackson's $5,000 mortgage and Jackson assumed Boyd's $6,000 mortgage. Boyd would report a long-term capital gain of

a. $4,000.
b. $3,000.
c. $2,000.
d. $1,000.
e. None of the above.

20. Refer to number "19" above. Jackson's tax basis in his land was $12,000. His tax basis in the new land is

a. $20,000.
b. $19,000.
c. $18,000.
d. $17,000.
e. None of the above.

Number 2 (Estimated time—50 to 60 minutes)

During the course of your audit of a new client, Warehouse Company, for the year ended December 31, 1966, you learned of the following transactions between Warehouse Company and another client, Investment Company:

1. Warehouse Company completed construction of a warehouse building on its own land in June 1965 at a cost of $500,000. Construction was financed by a construction loan from the Uptown Savings Bank.
2. On July 1, 1965 Investment Company bought the building from Warehouse Company for $500,000 which Warehouse Company used to discharge its construction loan.
3. On July 1, 1965 Investment Company borrowed $500,000 from Uptown Savings Bank to be repaid quarterly over four years plus interest at five per cent. A mortgage was placed on the building to secure the loan and Warehouse Company signed as a guarantor of the loan.
4. On July 1, 1965 Warehouse Company signed a noncancellable 10-year lease of the warehouse building from Investment Company. The lease specified that Warehouse Company would pay $65,000 per year for 10 years, payable in advance on each July 1, and granted an option, exercisable at the end of the 10-year period, permitting Warehouse Company to either (1) purchase the building for $140,000 or (2) renew the lease for an additional 15 years at $25,000 per year and purchase the building for $20,000 at the end of the renewal period. The lease specified that $10,650 of the annual payment would be for insurance, taxes, and maintenance for the following 12 months; if the lease should be renewed, $11,800 of each annual payment would be for insurance, taxes and maintenance.
5. The building has a useful life of 40 years and should be depreciated under the straight-line method (assume no salvage value).
6. Warehouse Company and Investment Company negotiated the lease for a

return of six per cent. You determine that the present value of all future lease payments is approximately equal to the sales price and that the sale-and-leaseback transaction is in reality only a financing arrangement.

Required:

For balance sheet presentation by Warehouse Company at December 31, 1966, prepare schedules computing the balances for the following items:

a. Prepaid insurance, taxes and maintenance.
b. Warehouse building, less accumulated depreciation.
c. Current liabilities arising from the lease.
d. Long-term liabilities arising from the lease.

Number 3 (Estimated time—40 to 50 minutes)

The partnership agreement of Jones, McDill, Gilrey, Carter and Adams contained a buy and sell agreement, among numerous other provisions, which would become operative in case of the death of any partner. Some provisions contained in the buy and sell agreement were as follows:

ARTICLE V. Buy and Sell Agreement

1. *Purposes of the Buy and Sell Agreement.*

(a) The partners mutually desire that the business shall be continued by the survivors without interruption or liquidation upon the death of one of the partners.

(b) The partners also mutually desire that the deceased partner's estate shall receive the full value of the deceased partner's interest in the partnership and that the estate shall share in the earnings of the partnership until the deceased partner's interest shall be fully purchased by the surviving partners.

2. *Purchase and Sale of Deceased Partner's Interest.*

(a) Upon the death of the partner first to die, the partnership shall continue to operate without dissolution.

(b) Upon the decedent's death, the survivors shall purchase and the executor or administrator of the deceased partner's estate shall sell to the surviving partners the deceased partner's interest in the partnership for the price and upon the terms and conditions hereinafter set forth.

(c) The deceased partner's estate shall retain the deceased partner's interest until the amount specified in the next paragraph shall be paid in full by the surviving partners.

(d) The parties agree that the purchase price for the partnership interest shall be an amount equal to the deceased partner's capital account at the date of death. Said amount shall be paid to the legal representative of decedent as follows:

(i) The first installment of 30 per cent of said capital account shall be paid within 60 days from the date of death of the partner or within 30 days from the date on which the personal representative of decedent becomes qualified by law, whichever date is later, and

(ii) The balance shall be due in four equal installments which shall be due and payable annually on the anniversary date of said death.

3. *Deceased Partner's Estate's Share of the Earnings.*

(a) The partners mutually desire that the deceased partner's estate shall be guaranteed a share in the earnings of the partnership over the period said estate retains an interest in the partnership. Said estate shall not be deemed to have an interest in the partnership after the final installment for the deceased partner's capital account is paid even though a portion of the guaranteed payments specified below may be unpaid and may be due and owing.

(b) The deceased partner's estate's guaranteed share of the earnings of the partnership shall be determined from two items and shall be paid at different times as follows:

(i) First, interest shall be paid on the unpaid balance of the deceased partner's capital account at the same date the installment on the purchase price is paid. The amount to be paid shall be an amount equal to accrued interest at the rate of 6 per cent per annum on the unpaid balance of the purchase price for the deceased partner's capital account.

(ii) Second, the parties agree that the balance of the guaranteed payment from the partnership earnings shall be an amount equal to 25 per cent of the deceased partner's share of the aggregate gross receipts of the partnership for the full 36 months preceding the month of the partner's death. Said amount shall be payable in 48 equal monthly installments without interest, and the first payment shall be made within 60 days following the death of the partner or within 30 days from the date on which the personal representative of deceased becomes qualified, whichever date is later; provided, however, that the payments so made under this provision during any twelve-month period shall not exceed the highest annual salary on a calendar-year basis received by the partner for the three calendar years immediately preceding the date of his death. In the event that said payment would exceed said salary, then an amount per month shall be paid which does not so exceed said highest monthly salary, and the term over which payments shall be paid to the beneficiary shall be lengthened out beyond the said 48 months in order to complete said payment.

Jones and Adams were both killed simultaneously in an automobile accident on January 10, 1966. The surviving partners notified the executors of both estates that the first payment due under the buy and sell agreement would be paid on March 10, 1966, and that subsequent payments would be paid on the tenth day of each month as due.

The following information was determined from the partnership's records:

Partner	*P & L Sharing Ratio*	*Capital Account on January 10, 1966*	*Annual Salaries to Partners by Years 1963*	*1964*	*1965*
Jones	30	$25,140	$16,500	$17,000	$17,400
McDill	25	21,970	15,000	15,750	16,500
Gilrey	20	4,780	12,000	13,000	14,000
Carter	15	5,860	9,600	10,800	12,000
Adams	10	2,540	8,400	9,600	10,800

The partnership's gross receipts for the three prior years were:

1963	$296,470
1964	325,310
1965	363,220

Required:

Prepare a schedule of the amounts to be paid to the Jones Estate and to the Adams Estate in March 1966, December 1966 and January 1967. The schedule should identify the amounts attributable to earnings and to interest in the guaranteed payments and to capital. Supporting computation should be in good form.

Number 4 (Estimated time—45 to 55 minutes)

You have been engaged to install an accounting system for the Kaufman Corporation. Among the inventory control features Kaufman desires as a part of the system are indicators of "how much" to order "when." The following information is furnished for one item, called a komtronic, which is carried in inventory:

1. Komtronics are sold by the gross (twelve dozen) at a list price of $800 per gross F.O.B. shipper. Kaufman receives a 40 per cent trade discount off list price on purchases in gross lots.
2. Freight cost is $20 per gross from the shipping point to Kaufman's plant.
3. Kaufman uses about 5,000 komtronics during a 259-day production year and must purchase a total of 36 gross per year to allow for normal breakage. Minimum and maximum usages are 12 and 28 komtronics per day, respectively.
4. Normal delivery time to receive an order is 20 working days from the date a purchase request is initiated. A rush order in full gross lots can be received by air freight in five working days at an extra cost of $52 per gross. A stockout (complete exhaustion of the inventory) of komtronics would stop production, and Kaufman would purchase komtronics locally at list price rather than shut down.
5. The cost of placing an order is $10; the cost of receiving an order is $20.
6. Space storage cost is $12 per year per gross stored.
7. Insurance and taxes are approximately 12 per cent of the net delivered cost of average inventory and Kaufman expects a return of at least 8 per cent on its average investment (ignore return on order and carrying cost for simplicity).

Required:

a. Prepare a schedule computing the total annual cost of komtronics based on uniform order lot sizes of one, two, three, four, five and six gross of komtronics.

(The schedule should show the total annual cost according to each lot size.) Indicate the economic order quantity (economic lot size to order).

b. Prepare a schedule computing the minimum stock reorder point for komtronics. This is the point below which the komtronics inventory should not fall without reordering so as to guard against a stockout. Factors to be considered include average lead-period usage and safety stock requirements.

c. Prepare a schedule computing the cost of a stockout of komtronics. Factors to be considered include the excess costs for local purchases and for rush orders.

GROUP II

Estimated time—50 to 60 minutes.

Solve one of the two problems in this group. If both are solved, only the first will be considered.

Number 5

The Melgar Company purchased a tract of land as an investment in 1963 for $100,000; late in that year the Company decided to construct a shopping center on the site. Construction began in 1964 and was completed in 1966; one third of the construction was completed each year. Melgar originally estimated the costs of the project would be $1,200,000 for materials, $750,000 for labor, $150,000 for variable overhead, and $600,000 for depreciation.

Actual costs (excluding depreciation) incurred for construction were:

	1964	*1965*	*1966*
Materials	$418,950	$434,560	$462,000
Labor	236,250	274,400	282,000
Variable overhead	47,250	54,208	61,200

Shortly after construction began, Melgar sold the shopping center for $3,000,000 with payment to be made in full on completion in December 1966. One hundred and fifty thousand dollars of the sales price was allocated for the land.

The transaction was completed as scheduled and now a controversy has developed between the two major stockholders of the Company. One feels the Company should have invested in land because a high rate of return was earned on the land. The other feels the original decision was sound and that changes in the price level which were not anticipated affected the original cost estimates.

You were engaged to furnish guidance to these stockholders in resolving their controversy. As an aid, you obtained the following information:

1. Using 1963 as the base year, price-level indices for relevant years are:

1960 = 90, 1961 = 93, 1962 = 96, 1963 = 100, 1964 = 105, 1965 = 112, and 1966 = 120.

2. The Company allocated $200,000 per year for depreciation of fixed assets allocated to this construction project; of that amount $25,000 was for a building purchased in 1960 and $175,000 was for equipment purchased in 1962.

Required:

a. Prepare a schedule to restate in base year (1963) costs the actual costs, including depreciation, incurred each year. Disregard income taxes and assume that each price-level index was valid for the entire year.

b. Prepare a schedule comparing the originally estimated costs of the project with the total actual costs for each element of cost (materials, labor, variable overhead, and depreciation) adjusted to the 1963 price-level.

c. Prepare a schedule to restate the amount received on the sale in terms of base year (1963) purchasing power. The gain or loss should be determined separately for the land and the building in terms of base year purchasing power and should exclude depreciation.

Number 6

The Township of Hamlet finances its operations from revenues provided by property taxes, water distribution, fines levied by the Municipal Court and interest on savings accounts.

Hamlet maintains only a general fund. You were engaged to conduct the audit for the year ended December 31, 1966 and determined the following:

1. General Fund account balances on January 1, 1966 were:

Cash in savings accounts	$ 62,030
Cash in checking accounts	38,450
Cash on hand (undeposited water receipts)	160
Water works supplies	3,640
Due from water customers	3,670
General Fund surplus	107,950

2. The budget for 1966 adopted by the city commission and the transactions relating to the budget (with all current bills vouchered and paid on December 31, 1966) for the year were:

	Budget	*Transactions*
Property taxes	$26,750	$26,750
Water works costs	66,500	64,360*
City constable and Court fees	10,000	9,550
Water revenues	30,000	32,060**
Court fines	12,500	11,025
Commissioners' salaries and expenses	6,000	5,470
Interest on savings accounts	2,000	2,240
Miscellaneous expenses	1,200	2,610

*Cash expenditures

**Billings

3. The commissioners appropriated sufficient General Fund surplus to balance budgeted revenues and appropriations. The difference was caused by anticipated repairs to water mains. It was also necessary to transfer $15,000 from a savings account to a checking account to pay for these repairs during 1966.

4. Your count of cash on December 31, 1966 determined that there was $250 on hand that was not deposited until January 2, 1967.

5. All billings for water during 1966 were paid with the exception of statements totaling $2,230 which were mailed to customers the last week of December.

6. All water works supplies were consumed during the year on the repair of water mains. Hamlet's charter specifies that appropriation expenditures are to be based on purchases.

Required:

Prepare a worksheet for the Township of Hamlet for the year ended December 31, 1966. Column headings should provide for: (1) a trial balance, (2) transactions for the year, (3) variances from budget and (4) a balance sheet at December 31, 1966. Formal statements and journal entries are not required.

EXAMINATION IN ACCOUNTING PRACTICE—PART II

November 2, 1967; 1:30 to 6:00 p.m.

All problems are required.

Number 1 (Estimated time—45 to 55 minutes)

You are examining the financial statements of Gant Corporation for the year ended December 31, 1966. You are satisfied that the $125,000 net income for the year (before provision for income taxes) was properly determined by the Corporation's bookkeeper under the accrual method of accounting, with possible exceptions arising from a Revenue agent's reports dated January 15, 1967, resulting from his examination of income tax returns for 1964 and 1965. Although the Corporation does not plan to contest the agent's findings, no entries were made on the books to record the following items contained in the reports:

1. The Corporation's 1965 income tax return reported a net operating loss and a claim for a refund from a carryback of the loss was filed. The Revenue agent's report, however, treated expenses totaling $12,000 in excess of the loss as a constructive dividend to a major stockholder.
2. The Corporation's 1964 income tax return included a deduction of $3,300 for equipment repairs. The agent's report disallowed the deduction but allowed depreciation over a three-year period with a $300 salvage value. A half year's depreciation was allowed for 1964.
3. In June 1964 the Corporation purchased an applicant's rights to a patent which was subsequently issued in July 1964. At year end the Corporation considered the patent worthless and deducted the $8,500 cost on its 1964 income tax return. In 1965 it was discovered that the patent applied to the product of another manufacturer who was licensed by Gant to use the patent for a fee of $600 per year which was included in book net income. The cost of the patent was not reinstated on the books. The Revenue agent disallowed the deduction on the 1964 return but allowed straight-line amortization of the patent cost. A half year's amortization was allowed in 1964.
4. The above changes on the Revenue agent's report resulted in income taxes due of $5,525 on the 1964 return and $2,195 on the 1965 return. Interest on the deficiencies amounted to $718.

During the course of your audit you noted the following items which were included in the determination of net income per books:

1. Cash dividends received from domestic nonaffiliated corporations totaled $4,500.
2. Interest totaling $150 was received from the United States Government on $5,000 of bonds issued March 1, 1940 and $410 in interest was received from the State of Illinois for highway bonds.
3. A milling machine, which was fully depreciated in 1959, was sold at a gain of $600. A shaping machine, which had been depreciated to its salvage value of $500, was sold for $300.
4. The mineral rights on a 200 acre tract of land were leased to an oil company for five years for a lease bonus (advance royalty) of $5 per acre. Mineral rights on the same tract had been leased to another oil company five years previously at a lease bonus of $10 per acre, but the oil company had paid a delay rental of $1 per acre each year not to drill a well and allowed the lease to expire in December 1966. No cost basis had been allocated to these mineral rights. The Corporation also received $10,000 of gross oil royalty payments from another tract of land and recorded $1,200 for cost depletion and $350 for pipeline taxes and expenses on the tract.
5. The Corporation is the beneficiary of its life insurance policies on the lives of key corporate officers. During the year the Corporation recorded as income the $25,000 proceeds from a term policy on the life of an officer who died. In addition the Corporation paid premiums of $3,000 during 1966 and the recorded cash surrender values of the policies increased by $1,775.
6. In October 1966 the Corporation paid $3,650 to State University as the final balance due on a $7,300 scholarship pledge made in October 1965. The $3,650 paid in 1965 was the Corporation's only charitable contribution in that year. In 1966 the Corporation also gave a lathe with a fair market value of $4,000 to Goodwill Industries (a qualified, nonprofit, charitable organization). The lathe was purchased new in 1959 for $6,000 and the Corporation had deducted $1,400 in 1959 and $480 per year thereafter in allowable depreciation. No depreciation was recorded on the books in 1966 on the lathe. The book value of the lathe was recorded as the amount of the contribution.
7. A block of 500 shares of Baco stock was sold for $2,200 on December 15, 1966. The Corporation had purchased 1,000 shares of Baco for $7,000 on November 29, 1965 and sold 500 shares for $2,500 on December 10, 1965. There were no other capital asset transactions in 1964, 1965 or 1966.

Required:

a. Prepare a schedule to determine Gant Corporation's income taxable for the year ended December 31, 1966 under the *Internal Revenue Code* and *Tax Regulations.*

b. Prepare a schedule of carryforward items as of December 31, 1966 which may be of future tax benefit. All supporting computations should be in good form.

Number 2 (Estimated time—30 to 40 minutes)

Ellford Corporation received a $400,000 low bid from a reputable manufacturer for the construction of special production equipment needed by Ellford in an expansion program. Because the Company's own plant was not operating at capacity, Ellford decided to construct the equipment there and recorded the following production costs related to the construction:

Services of consulting engineer	$ 10,000
Work subcontracted	20,000
Materials	200,000
Plant labor normally assigned to production	65,000
Plant labor normally assigned to maintenance	100,000
Total	$395,000

Management prefers to record the cost of the equipment under the incremental cost method. Approximately 40 per cent of the Corporation's production is devoted to government supply contracts which are all based in some way on cost. The contracts require that any self-constructed equipment be allocated its full share of all costs related to the construction.

The following information is also available:

1. The above production labor was for partial fabrication of the equipment in the plant. Skilled personnel were required and were assigned from other projects. The maintenance labor would have been idle time of nonproduction plant employees who would have been retained on the payroll whether or not their services were utilized.
2. Payroll taxes and employee fringe benefits are approximately 30 per cent of labor cost and are included in manufacturing overhead cost. Total manufacturing overhead for the year was $5,630,000.
3. Manufacturing overhead is approximately 50 per cent variable and is applied on the basis of production labor cost. Production labor cost for the year for the Corporation's normal products totaled $6,810,000.
4. General and administrative expenses include $22,500 of executive salary cost and $10,500 of postage, telephone, supplies and miscellaneous expenses identifiable with this equipment construction.

Required:

a. Prepare a schedule computing the amount which should be reported as the full cost of the constructed equipment to meet the requirements of the government contracts. Any supporting computations should be in good form.

b. Prepare a schedule computing the incremental cost of the constructed equipment.

c. What is the greatest amount that should be capitalized as the cost of the equipment? Why?

Number 3 (Estimated time—50 to 60 minutes)

Padre Company, a wholesaler, purchased 80 per cent of the issued and outstanding stock of Sun, Inc., a retailer, on December 31, 1962 for $120,000. At that date Sun, Inc. had one class of common stock outstanding at a stated value of $100,000 and retained earnings of $30,000. Padre Company had a $50,000 deficit balance in retained earnings.

Padre Company purchased the Sun, Inc. stock from Sun's major stockholder primarily to acquire control of signboard leases owned by Sun. The leases will expire on December 31, 1967, and Padre Company executives estimate the leases, which cannot be renewed, were worth at least $25,000 more than their book value when the stock was purchased.

The financial statements for both companies for the year ended December 31, 1966 follow:

Padre Company and Subsidiary

FINANCIAL STATEMENTS

For the Year Ended December 31, 1966

Balance Sheet

Assets	*Padre Company*	*Sun Inc.*
Cash	$ 14,200	$ 19,300
Accounts receivable	80,000	76,000
Inventories	54,800	85,600
Other current assets	15,000	18,200
Investment	120,000	
Notes receivable	8,000	
Land	25,000	10,500
Plant and equipment	200,000	40,000
Accumulated depreciation	(102,000)	(7,000)
Signboard leases		42,000
Amortization to date		(33,600)
Total	$ 415,000	$ 251,000
Liabilities and Capital		
Accounts payable	$ 35,500	$ 47,000
Dividends payable		9,000
Other current liabilities	24,500	12,000
Notes payable		8,000
Capital stock	300,000	100,000
Retained earnings	55,000	75,000
Total	$ 415,000	$ 251,000

Income Statement

	Padre Company	*Sun Inc.*
Sales	$ 420,000	$ 300,000
Cost of goods sold	315,000	240,000
Gross profit	105,000	60,000
Expenses	65,000	35,000
Net income	$ 40,000	$ 25,000

1. Padre Company sells merchandise to Sun, Inc. at the same prices and terms applicable to other customers. During 1966 Padre's sales to Sun totaled $100,000. Sun had $30,000 of merchandise purchased from Padre on hand on December 31, 1966 which was an increase of $10,000 over the previous year. Sun had not paid Padre for $21,000 of the merchandise in inventory and also owed Padre for a $15,000 cash advance which was in Sun's cash account on December 31, 1966.

2. On July 1, 1963, Sun purchased a parcel of land from Padre for $10,500 cash. A building on the land was also purchased the same date from Padre for $40,000; Sun paid $8,000 cash and gave a mortgage which called for four payments of $8,000 each plus interest at six per cent to be paid annually on the anniversary of the sale. Padre credits the interest paid by Sun to Interest Expense. The land originally cost Padre $10,500 and Padre's book value of the building was $30,000 at the date of the sale. Sun estimated the building had a twenty-year life and no salvage value when purchased and has computed depreciation on a monthly basis.

3. Sun declared a 9 per cent cash dividend on December 20, 1966, payable on January 16, 1967 to stockholders of record on January 2, 1967. Padre carries its investment at cost and had not recorded this dividend on December 31, 1966. Neither company paid a dividend during 1966.

Required:

Prepare a worksheet for the preparation of consolidated financial statements for the Padre Company and its subsidiary, Sun, Inc., as of December 31, 1966. The worksheet should show adjustments and eliminations, consolidated income statement and consolidated balance sheet and should include other accounts affected by the adjustments and eliminations. Formal statements and journal entries are not required. You may assume that both companies made all the adjusting entries required for separate financial statements unless an obvious discrepancy exists. Income taxes should not be considered in your solution.

Number 4 (Estimated time—50 to 60 minutes)

In the course of your audit of Mystic Company, you were requested to prepare comparative data from the Company's inception to the present. Toward this end you determined the following:

1. Mystic Company's charter became effective on January 2, 1962 when 1,000 shares of no-par common and 1,000 shares of 6 per cent cumulative, nonparticipating, preferred stock were issued. The no-par common stock was sold at its stated value of $150 per share, and the preferred stock was sold at its par value of $100 per share.

2. Mystic was unable to pay preferred dividends at the end of its first year. The owners of the preferred stock agreed to accept one share of common stock for every twenty shares of preferred stock owned in discharge of the preferred dividends due on December 31, 1962. The shares were issued on January 2, 1963, which was also the declaration date. The fair market value was $120 per share for common on the date of issue.

3. On April 30, 1964 Mystic paid a 10 per cent stock dividend in preferred stock (one share for every ten shares held) to all common stockholders. The fair market value of preferred stock was $85 per share on that date.

4. Mystic Company acquired all of the outstanding stock of Homes Corporation on May 1, 1964 in exchange for 600 shares of Mystic common stock. The transaction was recorded as a purchase. Homes reported a net income of $12,000 for its fiscal year ended April 30, 1964 and had reported a net income of $15,000 per year in each of its two prior years.

5. Mystic split its common stock three for two on January 1, 1965 and two for one on January 1, 1966.

6. Mystic tendered an offer to convert twenty per cent of the preferred stock to common stock on the basis of two shares of common for one share of preferred. The offer was fully accepted, and the conversion was made on July 1, 1966.

7. The Company reported the following in income statements for the years indicated:

Year	*Operating Income (Loss)*	*Other Income*	*Income Tax Expense*	*Net Income (Loss)*
1962	$(9,600)			$(9,600)
1963	23,421		$ 4,146 (1)	19,275
1964	47,920 (2)		16,960	30,960
1965	60,221 (2)	$13,200 (3)	25,706 (4)	47,715
1966	57,365 (2)		23,615 (5)	33,750

Notes:
(1) After net operating loss deduction; tax rate = 30%.
(2) Includes net income of combined companies.
(3) Gain from sale of land.
(4) Includes $3,300 tax on gain from sale of land.
(5) Includes $2,580 tax applicable to 1964.

8. No cash dividends were paid on common stock until December 31, 1964. Cash dividends per share of common stock were paid as follows:

	June 30	*December 31*
1964		$3.19
1965	$1.75	2.75
1966	1.25	1.25

Required:

a. Prepare schedules which show the computation of:

1. The number of shares of each class of stock outstanding on the last day of each year.

2. The number of shares of common stock outstanding each year expressed as a weighted average of the current equivalent shares. (A current equivalent share is a share adjusted for stock splits.)

3. Cash dividends paid on common stock.

b. Prepare a five-year summary of financial statistics by years of "Net Income," "Earnings per Share" and "Dividends per Share" for common stock and "Earnings

Coverage" for preferred stock. The summary is to be included in the Mystic Company's annual report and should be properly footnoted. Supporting computations should be in good form. (Earnings coverage indicates the number of times preferred dividends were earned).

Number 5 (Estimated time—45 to 55 minutes)

Crews Company produces a chemical agent for commercial use. The Company accounts for production in two cost centers: (1) Cooking and (2) Mix-Pack. In the first cost center liquid substances are combined in large cookers and boiled; the boiling causes a normal decrease in volume from evaporation. After the "batch" is cooked, it is transferred to Mix-Pack, the second cost center. The "batch" then has a quantity of alcohol added equal to the liquid measure of the "batch," is mixed, and bottled in one-gallon containers.

Material is added at the beginning of production in each cost center and labor is added equally during production in each cost center. Overhead is applied on the basis of 80 per cent of labor cost. The method of neglect is used in accounting for lost units (that is, all costs are allocated only to equivalent good units); the process is "in control" so long as the yield ratio for the first department is not less than 78 per cent.

The FIFO method is used to cost work-in-process inventories, and transfers are at an average unit cost, i.e., the total cost transferred divided by the total number of units transferred.

The following information is available for the month of October 1967:

Cost Information	*Cooking*	*Mix-Pack*
Work in process, October 1, 1967		
Materials	$ 990	$ 120
Labor	100	60
Prior department cost		426
Month of October		
Materials	39,600	15,276
Labor	10,050	16,000

Inventory and production records show that Cooking had 1,000 gallons 40 per cent processed on October 1 and 800 gallons 50 per cent processed on October 31; Mix-Pack had 600 gallons 50 per cent processed on October 1 and 1,000 gallons 30 per cent processed on October 31.

Production reports for October show that Cooking started 50,000 gallons into production and completed and transferred 40,200 gallons to Mix-Pack, and Mix-Pack completed and transferred 80,000 one-gallon containers of the finished product to the distribution warehouse.

Required:

a. Prepare in good form a quantity report for the Cooking cost center and for the Mix-Pack cost center which accounts for both actual units and equivalent unit production.

b. Prepare in good form a Production Cost Report for each of the two cost centers which computes total cost and cost per unit for each element of cost in inventories and October production. Total cost and cost per unit for transfers should also be computed.

c. Compute the yield ratio for Cooking and state whether or not the process was "in control" during October.

EXAMINATION IN AUDITING

November 2, 1967; 8:30 a.m. to 12:00 m.

GROUP I

Answer all questions in this group.

Number 1 (Estimated time—20 to 30 minutes)

Instructions

The auditor's report must contain an expression of opinion or a statement to the effect that an opinion cannot be expressed. Four types of opinions which meet these requirements are generally known as

a. An unqualified opinion.
b. A qualified opinion.
c. An adverse opinion.
d. A disclaimer of opinion.

For each of the following situations indicate the type of opinion which you would render by writing the appropriate letter from the above listing on a separate answer sheet. Select the **best** answer choice and mark only one answer for each item.

Unless there is an implication to the contrary in the situation as stated, you may assume that the examination was made in accordance with generally accepted auditing standards, that the financial statements present fairly the financial position and results of operations in conformity with generally accepted accounting principles applied on a consistent basis, and that the statements include adequate informative disclosure necessary not to be misleading.

An example of the manner in which the question should be answered is shown in the following illustration:

Question

XX. On the basis of an examination made in accordance with generally accepted auditing standards, the independent auditor formed the opinion that the financial statements present fairly financial position and results of operations in conformity with generally accepted accounting principles applied on a consistent basis and that the statements include all informative disclosures necessary to make the statements not misleading.

Answer Sheet

XX. a.

Questions to be Answered

1. During the course of his examination, the CPA suspects that a material amount of the assets of his client, Ash Corporation, have been misappropriated through fraud. The Corporation refuses to allow the auditor to expand the scope of his examination sufficiently to confirm these suspicions.

2. Balsam Corporation is engaged in a hazardous trade and cannot obtain insurance coverage from any source. A material portion of the Corporation's assets could be destroyed by a serious accident. The Corporation has an excellent safety record and has never suffered a catastrophe.

3. The CPA is examining the Chestnut Corporation's financial statements for the first time. Prior financial statements carry the unqualified opinion of a CPA who is unknown to the CPA currently conducting the examination. The CPA believes the balance sheet presents fairly the Corporation's financial position, but the CPA was not authorized to test the activity of prior periods and is unwilling to assume any responsibility for the work performed by the prior CPA.

4. Dogwood Corporation owns properties which have substantially appreciated in value since the date of purchase. The properties were appraised and are reported in the balance sheet at the appraised values with full disclosure. The CPA believes that the values reported in the balance sheet are reasonable.

5. The CPA is examining the financial statements which are to be included in the annual report to the stockholders of Elm Corporation, a regulated company. Elm Corporation's financial statements are prepared as prescribed by a regulatory agency of the United States Government and some items are not presented in accordance with generally accepted accounting principles. The amounts involved are material and are adequately disclosed in footnotes to the financial statements.

6. The CPA was engaged to examine the Fig Wholesale Corporation's financial statements after the close of the Corporation's fiscal year. On the completion of his examination the CPA is satisfied that the Corporation's financial statements are presented fairly except that the CPA is not satisfied that the Fig Wholesale Corporation's inventory is fairly stated on the balance sheet date. The amount of the inventory is material.

7. The CPA has examined Ginkgo Corporation's financial statements for many years. During the year just ended a service bureau was employed to process the Corporation's financial data by computer. The CPA knows very little about computers and does not wish to conduct the audit for the year just ended. The CPA and the president of the Corporation are old friends, however, and the president persuaded the CPA that he should not withdraw from the engagement. After glancing at the records and comparing the current year's statements with those of prior years, the CPA believes that the statements prepared by the service bureau are stated fairly.

8. Subsequent to the close of Holly Corporation's fiscal year a major debtor was declared a bankrupt due to a rapid series of events. The debtor had confirmed the full amount due to Holly Corporation at the balance sheet date. Since the account was good at the balance sheet date, Holly Corporation refuses to disclose any information in relation to this subsequent event. The CPA believes that all accounts were stated fairly at the balance sheet date..

9. Ivy Corporation has a subsidiary company in a foreign country. An inde-

pendent auditor in that country issued an unqualified opinion on the subsidiary's financial statements. Although the CPA is unaware of the standards of the practice of public accountancy in the foreign country, he is willing to accept full responsibility for the independent auditor's opinion on the subsidiary company's financial statements because he believes Ivy Corporation's internal audit staff performed an adequate check on the operations of the subsidiary company during the year. The CPA would be willing to express an unqualified opinion on the financial statements of Ivy Corporation alone, but he must express an opinion on the consolidated financial statements of Ivy Corporation and its subsidiaries.

10. The CPA has examined the financial statements of Juniper Corporation for many years and has always been able to render an unqualified opinion. Seven months ago the membership of the AICPA, in consensus with the authoritative organizations responsible for financial reporting standards, adopted (effective 90 days after adoption) only one of two procedures as proper for reporting a particular financial transaction. Juniper Corporation has applied the previously acceptable procedure for many years and consistently applied that procedure during the year just ended. The Corporation disclosed through footnotes to the current financial statements that the procedure employed is now at variance from the procedure adopted as being proper by the AICPA. The Corporation feels that lack of consistency is an overriding factor because the change in procedure would require it to report a material loss for the current year.

11. Kapok Corporation is a substantial user of electronic data processing equipment and has used an outside service bureau to process data in years past. During the current year the client adopted the policy of leasing all hardware and expects to continue this arrangement in the future. This change in policy is adequately disclosed in footnotes to the client's financial statements, but uncertainty prohibits either the client or the CPA from assessing the impact of this change upon future operations.

12. Linden Corporation has material investments in stocks of subsidiary companies. Stocks of the subsidiary companies are not actively traded in the market, and the CPA's engagement does not extend to any subsidiary company. The CPA is able to satisfy himself that all investments are carried at original cost, and he has no reason to suspect that the amounts are not stated fairly.

13. Maple Corporation has large investments in stocks of subsidiary companies, but the investments are not material in relation to the financial position and results of operations of the Corporation. Stocks of the subsidiary companies are not actively traded in the market, and the CPA's engagement does not extend to any subsidiary company. The CPA is able to satisfy himself that all investments are carried at original cost, and he has no reason to suspect that the amounts are not fairly stated.

14. Pecan Corporation has material investments in stocks of subsidiary companies. Stocks of the subsidiary companies are actively traded in the market, but the CPA's engagement does not extend to any subsidiary company. Management insists that all investments shall be carried at original costs and the CPA is satisfied that the original costs are fairly stated. The CPA believes that the client will never ultimately realize a substantial portion of the investments, but there is no disclosure to this effect in the financial statements.

15. Quassia Corporation has material investments in stocks of subsidiary companies. Stocks of the subsidiary companies are actively traded in the market, but the CPA's engagement does not extend to any subsidiary company. Management insists that all investments shall be carried at original costs and the CPA is satisfied that the original costs are fairly stated. The CPA believes that the client will never ultimately realize a substantial portion of the investments, and the client has fully disclosed the facts in footnotes to the financial statements.

Number 2 (Estimated time—25 to 30 minutes)

Late in December 1966 your CPA firm accepted an audit engagement at Fine Jewelers, Inc., a corporation which deals largely in diamonds. The Corporation has retail jewelry stores in several Eastern cities and a diamond wholesale store in New York City. The wholesale store also sets the diamonds in rings and in other quality jewelry.

The retail stores place orders for diamond jewelry with the wholesale store in New York City. A buyer employed by the wholesale store purchases diamonds in the New York diamond market, and the wholesale store then fills orders from the retail stores and from independent customers and maintains a substantial inventory of diamonds. The Corporation values its inventory by the specific identification cost method.

Required:

Assume that at the inventory date you are satisfied that Fine Jewelers, Inc. has no items left by customers for repair or sale on consignment and that no inventory owned by the Corporation is in the possession of outsiders.

a. Discuss the problems the auditor should anticipate in planning for the observation of the physical inventory on this engagement because of the
  1. Different locations of the inventories.
  2. Nature of the inventory.

b. 1. Explain how your audit program for this inventory would be different from that used for most other inventories.
  2. Prepare an audit program for the verification of the Corporation's diamond and diamond jewelry inventories, identifying any steps which you would apply only to the retail stores or to the wholesale store.

c. Assume that a shipment of diamond rings was in transit by Corporation messenger from the wholesale store to a retail store on the inventory date. What additional audit steps would you take to satisfy yourself as to the gems which were in transit from the wholesale store on the inventory date?

Number 3 (Estimated time—25 to 30 minutes)

Lakeview Development Corporation was formed on January 2, 1967 to develop a vacation-recreation area upon land purchased the same day by the Corporation for $100,000. The Corporation also purchased for $40,000 an adjacent tract of land which the Corporation plans to subdivide into fifty building lots. When the area is developed, the lots are expected to sell for $10,000 each.

The Corporation borrowed a substantial portion of its funds from a bank and gave a mortgage on the land. A mortgage covenant requires that the Corporation furnish quarterly financial statements.

The quarterly financial statements prepared at March 31 and June 30 by the Corporation's bookkeeper were unacceptable to the bank officials. The Corporation's president now offers you the engagement of preparing unaudited quarterly financial statements. Because of limited funds your fee would be paid in Lakeview Development Corporation common stock rather than in cash. The stock would be repurchased by the Corporation when funds become available. You would not receive enough stock to be a major stockholder.

Required:

a. Discuss the ethical implications of your accepting the engagement and the reporting requirements which are applicable if you should accept the engagement.

b. Assume that you accept the engagement to prepare the September 30 statements. What disclosures, if any, would you make of your prospective ownership of Corporation stock in the quarterly financial statements?

c. The president insists that you present the fifty building lots at their expected sales price of $500,000 in the September 30 unaudited statements as was done in prior statements. The writeup was credited to Contributed Capital. How would you respond to the president's request?

d. The Corporation elected to close its fiscal year at September 30, 1967 and you are requested to prepare the Corporation's federal income tax return. Discuss the implication of signing the return and the disclosure of your stock ownership in Lakeview Corporation (disregard the writeup of the land).

e. Assume that you accept the engagement to prepare the tax return. In the course of collecting information for the preparation of the return, you find that the Corporation's president paid the entire cost of a family vacation from corporate funds and listed the expense as travel and entertainment. You ascertain that the Corporation's board of directors would not consider the cost of the vacation as either additional compensation or a gift to the president if the facts were known. What disclosure would you make in (1) the tax return and (2) the financial statements?

f. After accepting your unaudited September 30 financial statements, the bank notified the Corporation that the December 31 financial statements must be accompanied by a CPA's opinion. You were asked to conduct the audit and told that your fee would be paid in cash. Discuss the ethical implications of your accepting the engagement.

Number 4 (Estimated time—25 to 30 minutes)

One of your clients, Bonded Warehousing Company, recently incorporated a subsidiary company to field warehouse petroleum products at a nearby industrial area. The parent company has engaged in terminal warehousing of lubricating oils and greases for a nearby petroleum refinery for some time. The refinery attempted to borrow against its light oil inventory but could do so only through a field warehousing arrangement. Bonded Warehousing was asked to field warehouse gasoline and diesel fuel for the refinery. The subsidiary leased the refinery's tank farm and undertook the field warehousing activity. The tank farm, which has adequate capacity for the refinery's output, has fifty tanks containing meters, alternate gauging openings and includes protection devices such as valve locks, burglar and fire alarms and fire fighting equipment. Only nonnegotiable warehouse receipts are issued.

The subsidiary employs only a stock record clerk, who keeps perpetual inventory records and issues warehouse receipts, and four yardmen, who do all loading and unloading of the tanks and take inventories. The parent company's home office receives all cash, writes all checks, and maintains all the records for the subsidiary company for a small monthly fee, and the home office internal control for these is excellent.

Required:

List the features which you believe would be desirable in a system of internal control over inventories for the subsidiary. Classify these controls in the following categories:

a. Controls at the field warehouse over receipts and releases of goods.

b. Other inventory controls at the field warehouse.

c. Specific controls which should be exercised by the home office after subsidiary operations are commenced.

d. Other related organizational or administrative matters which should be considered by the home office on or before the date subsidiary operations are commenced.

Number 5 (Estimated time—25 to 30 minutes)

You have completed your examination of the financial statements of Rumson Corporation for the year ended December 31, 1966, and are prepared to render an unqualified short-form auditor's report on the statements.

The board of directors now requests that you instead render your opinion in a long-form report and proposes that it include (1) a schedule of gross profit by branches, (2) a statement of funds flow and changes in working capital for the Corporation, (3) a schedule of inventories by locations and (4) the auditor's accounts receivable confirmation statistics. The board also indicates that Rumson's Northeastern Branch may be sold in the near future and requests a separate report containing the balance sheet and income statement of that branch.

Rumson Corporation has a main office and fourteen branches. Total 1966 sales aggregated $5,000,000 for the Corporation and the sales of individual branches ranged from $200,000 to $500,000. You visited seven branches, including the three largest, and conducted surprise tests of the records maintained at each, including cash on hand, accounts receivable, inventories, sales, payrolls and certain expenses. All branches of the Corporation exercise the same degree of control over operations and maintain the same records. At the main office you conducted supplementary audit tests for all branches. The Northeastern Branch, which had sales of $300,000, was not selected by you for a 1966 visit since the Branch was visited by an internal auditor in August 1966 and your October 1965 visit revealed that the records were in good condition.

Required:

a. Explain (1) why the auditor should learn the client's report requirements early in the engagement and (2) what steps can be taken to assure that this information is received when it is timely.

b. Describe the additional audit steps or other work, if any, necessary to enable you to comply with the board's wishes for each of the following additional report requirements:

1. Schedule of gross profit by branches.
2. Statement of funds flow and statement of changes in working capital.
3. Schedule of inventories by locations.
4. Accounts receivable confirmation statistics.
5. Northeastern Branch financial statements.

c. Assume that the Rumson board refuses to allow you to do any additional work for inventories by locations. Because this schedule must be a part of the report including your unqualified opinion on the financial statements, you will be required to explain the status of the inventory schedule above your signature in the report.

1. Why is such an explanation necessary?
2. List the facts you would include in the aforementioned explanation in order to conform with generally accepted reporting standards.

Number 6 (Estimated time—25 to 30 minutes)

You have just commenced your examination of the financial statements of Vickey Corporation for the year ended December 31, 1966. Analyses of the Company's Unexpired Insurance and Insurance Expense accounts follow.

Vickey Corporation
WORKSHEET FOR DISTRIBUTION OF INSURANCE
For Year Ended December 31, 1966

Date (1966)			Folio	Amount Debit	Amount Credit
		Unexpired Insurance			
January	1	Balance forward		$ 5,550	
	10	Premium on president's policy	CD	1,240	
	14	Deposit on workmen's compensation policy for 1966	CD	2,750	
	31	Monthly amortization	JE		$ 410
April	1	Down payment on fire policy (April 1, 1966 to April 1, 1971)	CD	1,000	
		Totals		$10,540	$ 410
		Insurance Expense			
January	10	Trip insurance on officers (Inspection tour of dealers in December 1965)	CD	$ 170	
	31	Monthly amortization	JE	410	
February	21	Balance on workmen's compensation policy (Per payroll audit for policy year ending December 31, 1965)	CD	250	
April	10	Automobile collision policy (Policy year April 1, 1966 to April 1, 1967)	CD	2,500	
June	10	Increase in fire policy (May 1, 1966 to April 1, 1971)	CD	590	
August	10	Fleet public liability and property damage policy (September 1, 1966 to September 1, 1967)	CD	3,780	
	17	Check from insurance company for reduction in auto collision rate for entire policy year	CR		$ 120
October	1	Fire policy payment	CD	1,300	
	19	Cost of repair to automobile damaged in a collision	CD	400	
		Totals		$ 9,400	$ 120

Your examination also disclosed the following information:

1. Only one policy of those prepaid at January 1, 1966 remained in force on December 31, and it will expire on March 31, 1967. The policy was a 24 month policy and the total premium was $600.

2. Cash value of the life insurance policy on the life of the president increased from $1,110 to $1,660 during 1966. The Corporation is the beneficiary on the policy.

3. The Corporation signed a note payable to an insurance company for the balance due on the fire insurance policy which was effective as of April 1. The note called for nine additional $1,000 semiannual payments plus interest at six per cent per annum on the unpaid balance (also paid semiannually).

4. An accrual dated December 31, 1965 for $170 for insurance payable was included among accrued liabilities.

5. Included in miscellaneous income was a credit dated April 10 for $100 for a four per cent dividend on the renewal of the automobile collision insurance policy. The insurance company is a mutual company. Also included in miscellaneous income was a credit dated November 2 for $350 for a check from the same insurance company for a claim filed October 19.

6. An invoice dated November 15 for $1,560 for employee fidelity bonds from November 15, 1966 to November 15, 1967 was not paid or recorded.

7. An invoice dated January 13, 1967 for $2,800 for the 1967 workmen's compensation policy was not recorded. The net amount of the invoice was $2,660 after a credit of $140 from the payroll audit for the year ended December 31, 1966.

Required:

Prepare a worksheet to properly distribute all amounts related to insurance for 1966. The books have not been closed for the year. The worksheet should provide columns to show the distribution to unexpired insurance, to insurance expense and to other accounts. The names of other accounts affected should be indicated. Formal journal entries are not required.

GROUP II

Estimated time—25 to 30 minutes

Answer one of the two questions in this group.

If both are answered, only the first will be considered.

Number 7

In the examination of a particular account, the auditor must test certain items within a finite population to form an opinion of the reliability of the account as a whole. In a judgment sample the auditor commonly tests most of the large dollar-amount items and a smaller proportion of lesser dollar-amount items. A random stratified sample makes the same type of selection, but is said to be superior to the judgment sample.

Required:

a. For each of the following define the terms and explain how the selection process could be applied to a test of accounts receivable:

1. A judgment sample.
2. A stratum in a finite population.
3. A systematic random stratified sample.

b. Explain why a random stratified sample is superior to a judgment sample.

c. Discuss sequential sampling and explain how and why this statistical technique might be more useful to an auditor than simple random sampling.

Number 8

The independent auditor must evaluate a client's system of internal control to determine the extent to which various auditing procedures must be employed. A client who uses a computer should provide the CPA with a flowchart of the information processing system so the CPA can evaluate the control features in the system. Shown opposite is a simplified flowchart, such as a client might provide. Unfortunately the client had only partially completed the flowchart when it was requested by you.

Required:

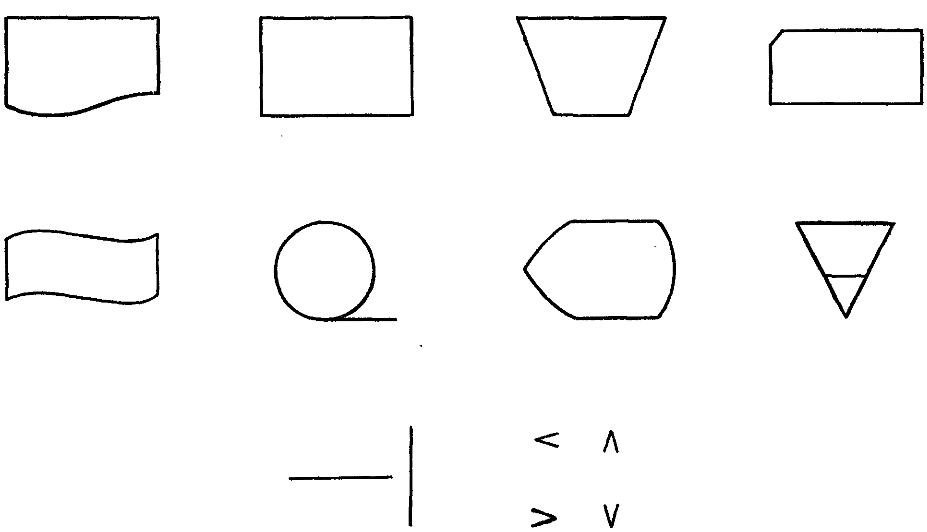
a. Complete the flowchart shown on page 190.

b. Describe what each item in the flowchart indicates. When complete, your description should provide an explanation of the processing of the data involved. Your description should be in the following order:

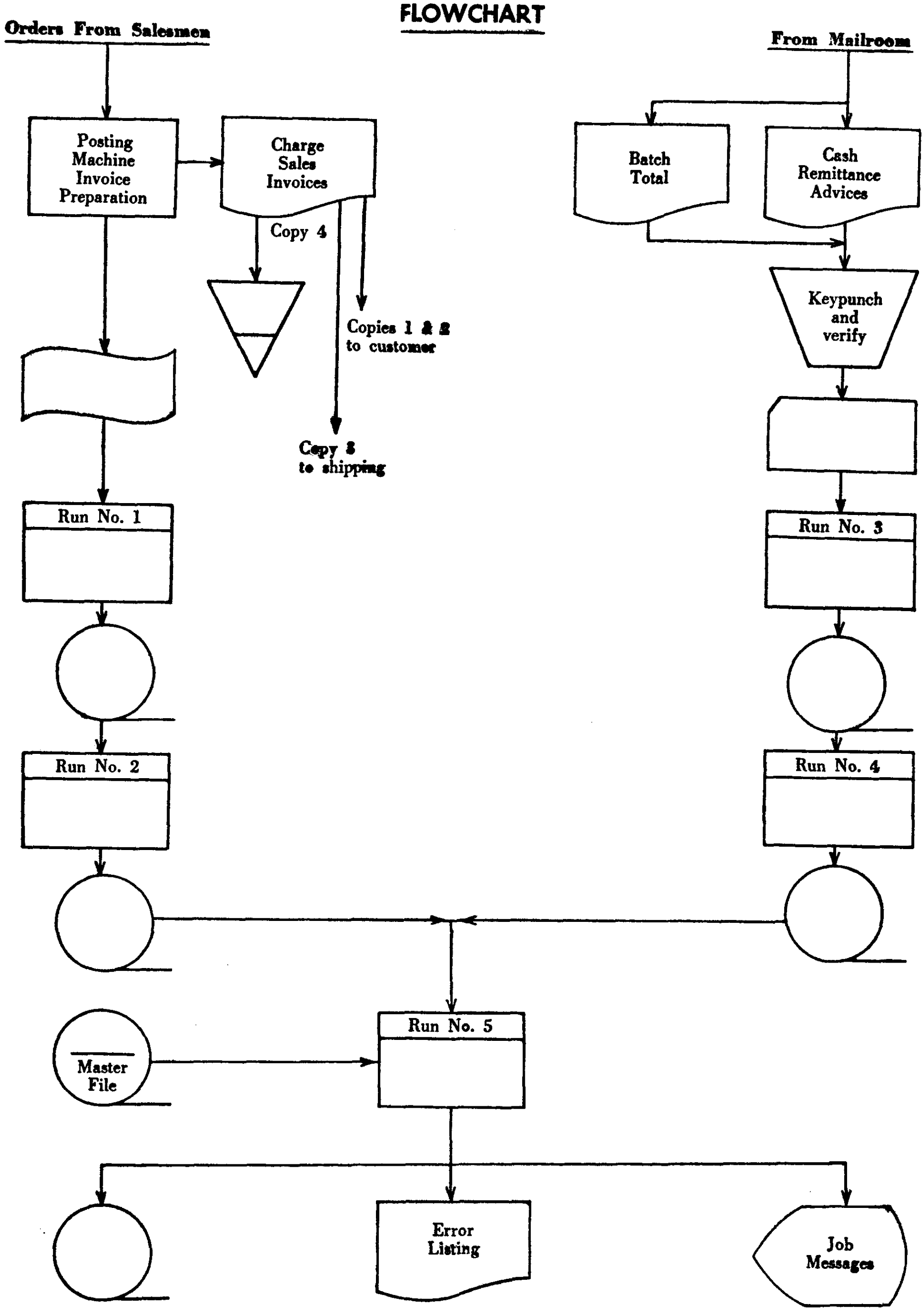
1. "Orders from Salesmen" to "Run No. 5."
2. "From Mailroom" to "Run No. 5."
3. "Run No. 5" through the remainder of the chart.

c. Name each of the flowchart symbols shown below and describe what each represents.

FLOWCHART SYMBOLS



FLOWCHART



Orders From Salesmen
From Mailroom
Posting Machine Invoice Preparation
Charge Sales Invoices
Copy 4
Copies 1 & 2 to customer
Copy 3 to shipping
Batch Total
Cash Remittance Advices
Keypunch and verify
Run No. 1
Run No. 2
Run No. 3
Run No. 4
Run No. 5
Master File
Error Listing
Job Messages

EXAMINATION IN COMMERCIAL LAW

November 3, 1967; 8:30 a.m. to 12:00 m.

All questions are required.

Number 1 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered statements states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to **general principles of contract law.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

An example of the manner in which the question should be marked is shown in the following illustration:

Question

XX. The following elements are necessary to constitute a pledge:
1. Possession by the pledgor.
2. Property used to secure a loan or other obligation.
3. Either real or personal property.
4. A right of redemption retained by the pledgor.
5. Title retained by the pledgor.

Answer Sheet

XX.
1. False
2. True
3. False
4. True
5. True

Questions To Be Answered

A. In order to have an enforceable contact there must be
   1. An agreement.
   2. A legal obligation.
   3. A writing.
   4. At least two parties.
   5. Mutual assent.

B. Anderson visited his accountant to arrange for the preparation of his tax return. A fee was not discussed, although Anderson expected to be charged. Under these circumstances
   6. An express contract to pay a reasonable fee is created.
   7. An implied contract to pay a reasonable fee is created.
   8. No contract is created.
   9. A voidable contract is created.
   10. An express bilateral contract is created whether or not mutual promises were exchanged.

C. Anfeld said to his accountant, Crane, "I promise to pay you $100 if you will agree to prepare my tax return."
   11. Anfeld's statement constituted an offer.
   12. When Crane agrees to prepare the return an executed contract exists.
   13. When Crane agrees to prepare the return an executory contract exists.
   14. A contract cannot exist prior to Crane's commencing the work.
   15. If Crane does not expressly agree, but he prepares the return, such action may constitute the making of the contract.

D. Peters offered in writing to sell his land to Sigaud for $10,000. Peters further promised in writing that he would hold his offer open for 30 days if Sigaud would promise to pay him an additional $100 anytime within the 30 day period, and Sigaud so promised.
   16. Sigaud has obtained a valid 30 day option to purchase Peters' land.
   17. Peters may revoke his offer to sell his land anytime prior to Sigaud's payment of $100.
   18. Sigaud may not effectively accept Peters' offer to allow Sigaud to purchase the land within 30 days at the specified price until Sigaud pays Peters $100.
   19. Peters may not rightfully sell his land to anyone other than Sigaud for 30 days, but Peters may revoke his offer to sell at anytime if he decides to keep the land for himself.
   20. If Sigaud accepts Peters' offer to sell the land within 30 days he need not pay an additional $100.

E. Riley embezzled funds while employed by Jones Company. Kara, internal auditor for Jones Company, later detected the embezzlement and the Company offered a reward for information leading to Riley's arrest. Simon provided information and as a result Riley was arrested. Simon is not entitled to receive the reward
   21. If he did not know of the offered reward when he gave the information.

22. If he knew of the offered reward, but the offer to pay the reward was made to a limited group of individuals which did not include Simon.
23. If he knew of the offered reward and the offer was made to him but he gave the information solely to relieve his conscience.
24. If he knew of the offered reward and the offer was made to him but he gave the information solely to avoid his own threatened arrest.
25. If he intended to accept the reward and the offer was made to him but he gave no indication before providing the information that he wanted to accept the offer.

F. Jaul offered Gold terms for a contract and asked Gold to accept his offer to contract by mail.

26. Gold's acceptance will not become effective until it is received by Jaul.
27. Gold's properly mailed letter of acceptance will be effective as of the date it is mailed only if it reaches Jaul within a reasonable time.
28. Gold's properly mailed letter of acceptance will be effective as of the date it was mailed even if it is lost in the mail.
29. Gold's acceptance communicated by telegraph will not be effective until it is received by Jaul.
30. If Gold properly mails a letter rejecting Jaul's offer and then changes his mind, Gold may not telephone Jaul before he receives the rejection letter and effectively accept the offer.

G. Although no consideration is given, a written promise may be enforceable where

31. The promise is to pay a past debt still existing and enforceable.
32. The promise is to pay a past debt barred by the Statute of Limitations.
33. The promise is to pay a past debt barred by bankruptcy.
34. The only reason that the promise is made is the promisor's love and affection for the promisee and the promisee took no action in reliance upon the promise.
35. The doctrine of promissory estoppel is applicable.

H. The Statute of Frauds

36. Does not apply to contracts created by law.
37. Does not apply to contracts which have been fully executed.
38. Does not apply to any contract involving less than $50 of value.
39. When applicable, may be satisfied by an unsigned written memorandum.
40. When applicable, may never be satisfied unless a writing evidencing the transaction has been delivered by one of the contracting parties to the other.

I. Where a written contract has been entered into, the parol evidence rule may be applied to prevent the admissibility of proof

41. Of an oral agreement made prior to the execution of the contract which contradicts the contract.
42. Of a written agreement made prior to the execution of the contract which contradicts the contract.
43. Of an oral agreement made prior to the execution of the contract which shows that no valid contract was entered into.

44. Of an oral agreement made prior to the execution of the contract which shows that the written contract does not contain the entire understanding of the parties.
45. Of an oral agreement made subsequent to the execution of the contract which contradicts the contract.

J. The doctrine of impossibility of performance will excuse a promisor from performing where
46. The subject matter of the contract is destroyed by an act of God.
47. Illness prevents the promisor from performing a personal service contract.
48. A change of law renders performance illegal.
49. The promisor's financial condition makes it impossible for him to perform.
50. A supplier of the promisor refuses to deliver goods which the promisor needs in order to be able to perform.

K. Decker contracts in writing to sell his house to Besen and then refuses to perform.
51. Besen may sue Decker and obtain specific performance of the contract and also a punitive money damage award.
52. Specific performance is the only possible remedy available for Besen.
53. Specific performance is not an available remedy if a similar house is available at a reasonable price.
54. Specific performance may be granted on the ground that a contract for the sale of real property is unique.
55. Only a court of law, as opposed to a court of equity, is empowered to grant the specific performance remedy.

L. Canale owes Murzin $100 and Murzin owes Stark the same amount. It is agreed among all three parties that Canale will pay Stark instead of Murzin, and that Murzin will terminate his legal relations with both and will be discharged.
56. The agreement is unenforceable because of lack of consideration.
57. The agreement constitutes an executed accord and satisfaction.
58. The agreement constitutes a novation.
59. The agreement constitutes merely an assignment of Murzin's rights against Canale to Stark.
60. Canale's becoming bankrupt prior to paying Stark would have no effect upon the agreement.

Number 2 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the **general principles of law and applicable provisions of the Uniform Commercial Code.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. Unless a contrary intention appears, a buyer purchasing equipment is protected by a warranty that

61. The price charged for the equipment is a reasonable one.
62. The seller's title to the equipment conveyed is good.
63. The seller of the equipment is financially solvent.
64. The seller of the equipment will remain in business for a reasonable length of time to be able to service the goods sold.
65. The equipment shall be delivered free from any security interest of which the buyer at the time of contract has no knowledge.

B. Express warranties are created

66. By a seller's stating his opinion as to the value of goods.
67. By a seller's stating his opinion as to the length of time the goods will provide trouble free service.
68. By a seller's displaying a sample or model and stating that all of the goods shall conform to it.
69. By a seller's describing the goods and stating that all of the goods shall conform to the description.
70. By a seller's making an affirmation which is excluded from being part of the basis of the bargain.

C. Fassler sells Karasyk a washing machine to be delivered within 30 days after the sale. When a machine was delivered within 5 days after the sale, it was found that a mistake was made and the wrong model was delivered. In such a case

71. Karasyk must accept delivery of the nonconforming machine and sue Fassler for damages.
72. Karasyk may reject delivery and refuse to take immediate delivery of the correct machine.
73. Fassler may within the 30 days allowed for delivery notify Karasyk of his intention to supply the correct machine and may then make a proper delivery within the 30 days allowed.
74. Fassler may within the 30 days allowed for delivery notify Karasyk of his intention to supply the correct machine and then make a proper delivery within a reasonable time after the 30 days have elapsed.
75. Since he has breached the sales contract, Fassler may not deliver the correct machine to Karasyk without first obtaining his consent.

D. The warranty of merchantability

76. Is an implied warranty only if the seller of goods is a merchant with respect to the goods sold.
77. Is an implied warranty in any sale.
78. Does not extend to the serving for value of food or drink in a restaurant as this is a service and not a sale.

79. Means that goods must always be above average quality.
80. Extends to the adequacy of the container in which the goods are packaged.

E. The warranty of fitness for a particular purpose
81. Is never an implied warranty.
82. Cannot exist if goods are purchased by tradename.
83. Cannot exist if the buyer has not relied on the seller's skill or judgment to select suitable goods.
84. If applicable, cannot be excluded by disclaimer.
85. If applicable, may be excluded by a course of dealing between the parties.

F. A seller's warranty
86. Extends to any person who comes in contact with the goods sold.
87. Extends only to the buyer.
88. May extend to persons other than the buyer only if the warranty is an express warranty.
89. May extend to a member of the buyer's family.
90. May extend to a guest in the buyer's home.

G. The concept of passage of title
91. No longer remains as important as it once was in determining rights of buyers and sellers.
92. Governs who bears risk of loss.
93. Always determines whether an action for the price may be maintained, as contrasted with an action for damages.
94. Always determines the seller's right to reclaim goods sold.
95. Always determines insurable interest.

H. The term "F.O.B."
96. Means "free on board."
97. Means "freight on board."
98. May control who bears the risk of loss of goods in transit.
99. May control who bears the expense of shipping goods.
100. Standing alone is an incomplete statement of a delivery term.

I. The term "F.A.S."
101. Means "freight and shipping."
102. Means "free alongside."
103. May control who bears the risk of loss of goods in transit.
104. When used, may require the buyer to give needed instructions for making delivery of the goods.
105. Should not be used together with the term "F.O.B.," as the terms used together would be contradictory.

J. The term "C.I.F."
106. Means that the price includes the cost of the goods and the insurance and freight to the named destination.
107. Means cash is to be paid if the goods are to be forwarded.

108. When used, requires the buyer, unless otherwise agreed, to obtain insurance to cover goods in transit.
109. When used, still requires the buyer, unless otherwise agreed, to make payment against required documents of title for the goods which are held by the seller's agent.
110. Should be used together with the statement of a named destination for goods to be shipped.

K. Under a sale on approval, unless otherwise agreed,
111. The risk of loss does not pass to the buyer until acceptance although the goods are identified to the contract.
112. Title to the goods passes to the buyer on receipt by him of the goods if the goods are identified to the contract.
113. Use of the goods consistent with the purpose of trial constitutes an acceptance of the goods by the buyer.
114. Failure by the buyer to give timely notification to the seller of his election to return the goods constitutes an acceptance of the goods.
115. Acceptance of any part of the goods is acceptance of the whole of the goods if the goods conform to the contract.

L. When goods have been delivered by a seller to a buyer under a transaction of purchase, the buyer has power to effectively transfer a good title to the goods to a good faith purchaser for value
116. Even though the seller was deceived as to the identity of the buyer.
117. Even though the delivery of the goods by the seller was in exchange for a check which was later dishonored.
118. Even though there was an agreement between the seller and the buyer that the transaction was to be a "cash sale" but cash was not received by the seller.
119. Even though the delivery was procured through fraud.
120. Only if the good faith purchaser for value is a merchant.

Number 3 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether each of the legal conclusions is true or false according to the **general principles of corporation law.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. If twenty persons are in business as partners and wish to form a corporation to carry on the business, the corporation must be incorporated in a state in which
121. The corporation plans to carry on the major portion of its activities.

122. At least one of the incorporators intends to reside during the time that the corporation is to remain in existence.
123. The majority of the incorporators reside at the time of incorporation.
124. The partnership was established.
125. The partnership carries on the major portion of its activities.

B. A shareholders' agreement may

126. Provide for a mandatory purchase of shares from a shareholder's estate upon his death.
127. Restrict the sale of securities to outside parties until present shareholders are given the opportunity to purchase the shares.
128. Bind shareholders to vote to dissolve the corporation in the event of a deadlock.
129. Bind shareholders to seek arbitration in the event certain disputes arise.
130. Bind nonassenting shareholders to its terms if a majority of shareholders sign the shareholders' agreement.

C. In order for a corporation to obtain *de facto* status, there must be

131. A special statute passed by the legislature allowing for such status.
132. A statute under which the corporation might have been validly incorporated.
133. Some exercise of corporate privileges.
134. A good faith attempt to comply with the incorporation law.
135. The correction of any defect prior to the payment of any debt.

D. Rolling Corporation transferred part of its assets to a new corporation in exchange for the latter's stock and then immediately distributed such stock to Rolling Corporation's shareholders without requiring them to surrender any of their Rolling Corporation stock. Such a transaction

136. Is illegal.
137. Constitutes a stock split.
138. Constitutes a spin off.
139. Increases the par value of Rolling Corporation's stock.
140. Constitutes an *ultra vires* act even though authorized by Rolling Corporation's charter.

E. Lillian Corporation and Feld Corporation join to form a new corporation, Lillianfeld, Inc. Such a transaction

141. Is referred to as a merger.
142. Is referred to as a consolidation.
143. Is referred to as an acquisition.
144. May not occur without the consent of all of the shareholders of each corporation.
145. May provide some shareholders with the right to an appraisal remedy.

F. "Blue Sky Laws"

146. Refer to outdated statutes regulating the incorporation of corporations.
147. Need not be complied with if the stock of a corporation is publicly traded on an exchange.
148. Refer to state statutes regulating the issuance and sale of securities.

149. Are administered by the Securities and Exchange Commission.
150. Refer to federal statutes regulating corporations.

G. Directors of a corporation generally have the power to
151. Appoint their successors.
152. Replace officers.
153. Declare dividends.
154. Set salaries for executives.
155. Require shareholders to sell stock.

H. Where a corporation is insolvent and a dividend has been declared
156. A shareholder may obtain a court injunction to prevent the payment of the dividend.
157. A creditor may obtain a court injunction to prevent the payment of the dividend.
158. The dividend may be required to be returned to the corporation if paid.
159. The payment of such a dividend would constitute a fraud against the creditors.
160. The declaration of such a dividend by the board of directors in good-faith reliance on an improper balance sheet would not necessarily constitute a breach of trust.

I. A cash dividend
161. Becomes a debt of the corporation once it is validly declared.
162. May be sued for by a shareholder if it is not paid once it is validly declared.
163. Must be declared when more than adequate earnings exist.
164. May be ordered by a court even if there is no evidence that withholding its declaration is an abuse of discretion.
165. Is payable only from funds legally available for such purpose.

J. Cumulative voting
166. Applies only to the election of directors.
167. Assures each voter that at least one of his candidates will be elected.
168. Is always in effect for preferred shares.
169. Is not as effective when the number of persons to be elected is decreased.
170. May be made mandatory by statute.

K. The "preemptive rights" doctrine
171. Allows preferred shareholders to assume control of the corporation if dividends are not paid.
172. Protects a shareholder's interest in the corporation in the event of the issue of additional shares.
173. Allows the directors to replace officers of the corporation at will.
174. Requires directors to turn over all corporate opportunities to the corporation.
175. Insures the payment of a dividend to the shareholder of record on the record date.

L. Treasury stock
   176. Is authorized stock.
   177. Is issued stock.
   178. Is outstanding stock.
   179. May be voted.
   180. May participate in dividends.

Number 4 (Estimated time—20 to 25 minutes)

Part a. Franklin, a depositor of the Milltown Bank, orally ordered the cashier of the bank to stop payment on a check which he had issued. The check was issued in payment for goods which were not received. Franklin learned that the seller was a notorious confidence man.

The cashier in turn notified the tellers that an oral stop order had been given. Ten days later one of the tellers, who was not paying much attention to his business, paid the seller's wife, who had been sent to the bank to cash the check for the seller. Franklin, while examining his cancelled checks at the end of the month, discovered the error and promptly notified the cashier. The cashier apologized but pointed out that the original application, which Franklin signed at the time that the checking account was opened, contained a clause disclaiming any and all liability on the bank's part for erroneously paying an item in disregard of a customer's outstanding stop order. The cashier further indicated that the stop order was not in writing and, therefore, was invalid in any event.

Required:

1. Was the oral stop order valid? **Discuss.**
2. Can the bank rely upon the disclaimer clause to avoid liability? **Discuss.**
3. Suppose the bank limited its liability on improper payment of checks to ten dollars per item despite the presence of an outstanding stop order. Would the bank be liable for any amount in excess of ten dollars? **Discuss.**

Part b. Newton, a holder in due course, presented a check to the Marshall Bank, the drawee bank named on the face of the instrument. The bank examined the signature of the drawer very carefully, but the signature was such an exact forgery of the drawer's signature that only a handwriting expert could have detected a difference. The bank therefore paid the check.

Required:

1. Assume that the check was promptly returned to the drawer-depositor but that he did not discover the forgery until thirteen months after the check was returned to him. Can he compel the bank to credit his account for the loss?
2. Assume that the bank discovered the forgery before returning the check to the drawer-depositor and credited his account. Can the bank in turn collect the amount paid to Newton? **Discuss.**
3. How would your answers to "1" and "2" above be modified if the forged

signature was that of the payee or an indorser rather than the signature of the drawer? **Discuss.**

Number 5 (Estimated time—20 to 25 minutes)

Part a. Mark, a certified public accountant, was engaged by Franklin Corporation to compute the net income attributable to the sale of certain products by the Corporation for the year 1964. The purpose of this special engagement was to provide the basis for determination of the year-end bonuses payable to the sales personnel responsible for those sales. Mark was fully informed of the purpose of the engagement.

Mark was negligent in the performance of his engagement. As a result several of the key salesmen received substantially less than the amount they were entitled to receive.

The Franklin Corporation is currently bankrupt and unable to pay the claims of the salesmen. However in the year 1964 the Corporation was solvent and could have paid the proper amounts.

Required:

Can the salesmen recover from Mark the loss they suffered as a result of his negligence? **Explain.**

Part b. The Federal Securities Act of 1933, which regulates the public offering of securities through the mails or in interstate commerce, included some major provisions regarding accountants' legal liability.

Required:

List and explain the major provisions affecting accountants' legal liability which were incorporated in the Securities Act of 1933.

Part c. Star, a certified public accountant, accepted an offer from Granite Corporation to become the Corporation's controller. The contract was for three years and expressly provided that it was "irrevocable by either party except for cause" during that period of time. It was in writing and signed by both parties to the contract.

After a year elapsed, Star became dissatisfied with the agreed compensation which he was receiving. He had done an excellent job as controller and several larger competing corporations were attempting to lure him away from Granite. Star, therefore, demanded a substantial raise and the Corporation agreed in writing to pay him an additional amount at the end of the third year. Star remained with the Corporation and performed the same duties he had agreed to perform at the time he initially accepted the position as controller.

At the end of the three years Star sought to collect the additional amount of money promised. The Corporation denied liability beyond the amount agreed to in the original contract.

Required:

Can Star recover the additional compensation from Granite Corporation? **Explain.**

Part d. The basic facts are the same as stated in part "c" except that one of Granite's competitors, Jackson Corporation, successfully lured Star away from Granite Corporation by topping Granite's offer of additional compensation. Jackson Corporation did this with full knowledge of the terms of the original three-year contract between Star and Granite.

Required:

1. Does Granite Corporation have any legal redress against Jackson Corporation? **Explain.**
2. Granite Corporation, relying on the contract's stated irrevocability for three years, seeks the equitable relief of specific performance, i.e., an order by the court compelling Star to perform his contractual undertaking. Will Granite prevail? **Explain.**

Number 6 (Estimated time—20 to 25 minutes)

John Barry, a world famous golfer, represents Golf Cart Company, Inc. as a sales agent to promote sales of the Company's product, a golf cart. The Company sells a new type of golf cart which it has named the "Barry Golf Cart," and it has commenced an extensive marketing campaign. As a part of this campaign the Company sends letters advertising the cart to presidents of golf clubs. In its letter the Company represents that the new cart "can be driven a full 18 holes of golf under any conditions" and that "the cart will not require any major repair for two years." Also in the letter, which is signed by John Barry as vice president in charge of sales promotion, there is a statement by John Barry that he "personally tested the cart and was delighted with its performance."

Jones, a president of a golf club, bought a golf cart after reading the letter and corresponding with the Company to determine the model which best suited his needs. He now finds that the cart is totally unsatisfactory since it continuously breaks down when it is driven on the golf course. He has informed Barry that he intends to bring a suit for damages against both the Company and Barry in his individual capacity. However, he further states that if he could be sure that Golf Cart Company, Inc. is solvent he would not sue Barry individually but would sue only the Company. To determine the Company's financial status, he asks Barry to secretly allow him access to the Company's financial records. Barry suspects that Jones may have other motives for wishing to secretly view the Company's records.

Required:

a. Explain the legal relationship which exists between Barry and Golf Cart Company, Inc.

b. What should Barry do with regard to arranging for Jones to secretly examine the Company's financial records to avoid a suit against himself individually?

c. What legal theory would support a suit brought by Jones against Golf Cart Company, Inc.? Describe the necessary elements to be proved to justify a recovery.

d. In the event that Barry is sued individually by Jones, what defense(s) is (are) available to him? **Explain.**

Number 7 (Estimated time—25 to 30 minutes)

Part a. You are the accountant for Harry Scanlon, a farmer who owns land which borders on the right-of-way of the Western-Eastern Railroad. Harry explains to you that, due to the admitted negligence of the Railroad, hay on Harry's land worth $2,000 was set afire and burned. Harry filed a claim with the Railroad and with his fire insurance company and collected $2,000 from his fire insurance company. At the time the company paid, the representative mentioned that the company was considering suing the Railroad, but no suit has commenced.

Six months have passed and Harry has now been contacted by the Railroad, which wishes to settle his claim. The Railroad is unaware that Harry has been indemnified by his fire insurance company. Harry has had a dispute with the Railroad for several years concerning the ownership of a small parcel of land and the representative of the Railroad has offered to assign any rights which the Railroad may have in the land to Harry in exchange for a release of his right to reimbursement for the loss he has sustained from the fire. Harry is inclined to accept the Railroad's offer, particularly since he has already been fully indemnified by his fire insurance company for the fire loss he sustained.

Required:

1. On the basis of what legal or equitable theory, if any, would the fire insurance company have a right to institute an action against the Railroad? **Explain.**
2. Could the first insurance company institute an action against the Railroad prior to settling Harry's claim in full? **Explain.**
3. May Harry Scanlon properly retain the payment made to him by his fire insurance company and also accept the Railroad's offer? **Explain.**

Part b. Joseph Price bought a building valued at $100,000. Upon the purchase, Price's insurance agent suggested that he obtain fire insurance. The agent recommended a policy with an 80 per cent co-insurance clause. Price agreed to such a policy but requested that the face value of the policy be limited to $60,000. Shortly after obtaining the insurance, a fire occurred causing damage of $50,000 to the building.

Required:

1. What is meant by the term "co-insurance"? Explain the effect of co-insurance on the recovery of a loss.

2. Discuss the basis for computing Price's recovery from the insurance company because of the fire. Show the computation in your answer.

3. Compute the amount Price would recover if the fire had completely destroyed the building.

Number 8 (Estimated time—25 to 30 minutes)

For several years Martin supplied raw materials to Brown who processed the goods into a finished product for sale to retail customers.

Martin supplied goods to Brown on credit terms and, to secure his claim for unpaid goods, Martin obtained and properly perfected a "floating lien" on all of the goods sold to Brown.

Six months ago Martin heard that Brown was in financial difficulty and stopped selling goods to him. Martin was not paid by Brown for several shipments of goods and heard that recently Brown made a general assignment for the benefit of his creditors. Also Martin heard that a group of Brown's creditors may attempt to place Brown into bankruptcy.

Required:

a. 1. Has Brown committed an "act of bankruptcy"? **Explain.**

2. Is the commission of an "act of bankruptcy" necessary to become a voluntary bankrupt? **Explain.**

3. Under what circumstances may Brown's creditors proceed to have Brown adjudicated an involuntary bankrupt?

4. Assume that Brown's creditors may proceed to have him adjudicated an involuntary bankrupt. What action would they have to take in order to commence a bankruptcy proceeding?

5. Will the number of creditors required to commence an involuntary bankruptcy proceeding vary depending upon the number of Brown's creditors? **Explain.**

b. 1. Explain the meaning of the term "floating lien."

2. Is such a lien valid? **Explain.**

3. Describe the steps that are required to have the "floating lien" "attach" and become "perfected."

c. How will Martin be treated in the bankruptcy proceedings if Brown is adjudicated a bankrupt? **Explain.**

EXAMINATION IN THEORY OF ACCOUNTS

November 3, 1967; 1:30 p.m. to 5:00 p.m.

All questions are required.

Number 1 (Estimated time—25 to 30 minutes)

Instructions

Select the best answer for each of the following items. Write your answer choice on a separate paper. Mark only one answer for each item.

An example of the manner in which the answer sheet should be marked is shown in the following illustration:

Item

XX. Opinions of the Accounting Principles Board apply only to items that are
- a. Immaterial.
- b. Material and significant.
- c. In excess of ten per cent of net income.
- d. In excess of twenty per cent of net income.

Answer Sheet

XX. b.

Items to be Answered

1. If bonds are initially sold at a discount and the straight line method of amortization is used, interest expense in the earlier years
   - a. Will exceed what it would have been had the scientific (compound interest) method of amortization been used.
   - b. Will be less than what it would have been had the scientific method of amortization been used.
   - c. Will be the same as what it would have been had the scientific method of amortization been used.
   - d. Will be less than the coupon rate of interest.

2. Cash dividends are usually declared on one date, payable on a subsequent date to stockholders of record on some intermediate date. At which of the following dates has the investor stockholder theoretically realized income from the dividend?

   a. The date the dividend is declared.
   b. The date of record.
   c. The date the dividend check is mailed by the corporation.
   d. The date the dividend check is received by the stockholder.

3. Each year a company has been investing an increasingly greater amount in machinery. Since there are a large number of small items with relatively similar useful lives, the company has been applying straight line depreciation of a uniform rate to the machinery as a group. The ratio of this group's total accumulated depreciation to the total cost of the machinery has been steadily increasing and now stands at .75 to 1.00. The most likely explanation of this increasing ratio is:

   a. The company should have been using one of the accelerated methods of depreciation.
   b. The estimated average life of the machinery is less than the actual average useful life.
   c. The estimated average life of the machinery is greater than the actual average useful life.
   d. The company has been retiring fully depreciated machinery that should have remained in service.

4. The theory of accounting which best describes the accounting equation expressed "assets = liabilities + proprietorship" is the

   a. Entity theory.
   b. Fund theory.
   c. Proprietary theory.
   d. Residual equity theory.

5. When a material item of revenue or expense is recognized on the income statement in a period different from the period in which it is recognized for income tax purposes, which of the following accounting methods will materially distort net income reported on the income statement?

   a. Liability method of interperiod tax allocation.
   b. Deferred method of interperiod tax allocation.
   c. Net of tax method of interperiod tax allocation.
   d. Non-recognition of deferred or prepaid taxes.

6. At the end of the fiscal year substantial variances from standard variable manufacturing cost should be allocated to inventories and cost of sales if they were due to

   a. Additional costs of raw material acquired under a speculative purchase contract.
   b. Increased labor rates won by the union as a result of a strike during the year.
   c. A breakdown of equipment.
   d. Overestimates of production volume for the period resulting from failure to predict an unusual decline in the market for the Company's product.

7. The total of the partners' capital accounts was $110,000 before recognition of partnership goodwill in preparation for the withdrawal of a partner whose profit and loss sharing ratio is 2/10. He was paid $28,000 by the firm in final settlement for his interest. The remaining partners' capital accounts excluding their share of the goodwill totaled $90,000 after his withdrawal. The total goodwill of the firm agreed upon was

a. $40,000.
b. $28,000.
c. $20,000.
d. $ 8,000.

8. The acquisition cost of a certain raw material changes frequently. The book value of the inventory of this material at year end will be the same if perpetual records are kept as it would be under a periodic inventory method only if the book value is computed under the

a. Weighted average method.
b. First-in, first-out method.
c. Last-in, first-out method.
d. Base stock method.

9. In considering whether to replace a major item of machinery now or at the end of its useful life one should ignore

a. Opportunity costs.
b. Fixed costs.
c. Sunk costs.
d. Imputed costs.

10. An item of inventory purchased this period for $15.00 has been written down to its current replacement cost of $10.00. It sells for $30.00 with disposal costs of $3.00 and normal profit of $12.00. Which of the following statements is *not* true?

a. The cost of sales of the following year will be understated.
b. The current year's income is understated.
c. The closing inventory of the current year is understated.
d. Income of the following year will be understated.

11. When preferred stock is purchased and retired by the issuing corporation for less than its original issue price, proper accounting for the retirement

a. Increases the amount of dividends available to common shareholders.
b. Increases the contributed capital of the common shareholders.
c. Increases reported income for the period.
d. Increases the treasury stock held by the corporation.

12. In the preparation of consolidated financial statements, for which of the following intercompany items will eliminations *not* be made?

a. Purchases and sales where the parent employs the equity method.
b. Receivables and payables where the parent employs the cost method.
c. Dividend income and dividends paid where the parent employs the equity method.
d. Dividends receivable and payable where the parent employs the equity method.

13. Which of the following is a revenue expenditure?
   a. Cost of major reconditioning of a recently acquired second-hand lift truck.
   b. Machine operator's wages during period of testing and adjustment of new machinery.
   c. Cost of new structural components installed in a warehouse endangered by land erosion.
   d. Partitions installed in rented quarters to effect changes in room arrangements required to accommodate a new tenant.

14. If four separate carriers have written fire insurance policies totaling $60,000 on a single property valued at $100,000, what fraction of a partial loss of $20,000 will be collectible from a carrier whose $30,000 policy contains a 90 per cent co-insurance clause?
   a. 60/90
   b. 30/90
   c. 30/60
   d. 20/100

15. The cost of purchasing patent rights for a product that might otherwise have seriously competed with one of the purchaser's patented products should be
   a. Charged off in the current period.
   b. Amortized over the legal life of the purchased patent.
   c. Added to factory overhead and allocated to production of the purchaser's product.
   d. Amortized over the remaining estimated life of the patent for the product whose market would have been impaired by competition from the newly patented product.

16. Which of the following circumstances does *not* warrant the write-up of property, plant and equipment to reflect appraisal, market or current values which are above cost to the entity?
   a. A quasi-reorganization in which tangible fixed assets are written up, even though the net effect of all asset revaluations is a write-down.
   b. A formal reorganization.
   c. Foreign operations in a period of currency revaluation.
   d. When depreciation computed on original cost is less than the depreciation that would be computed on replacement cost.

17. The effect of changes in volume on semi-variable costs may be approximated by means of a statistical technique employing
   a. Linear programming.
   b. Calculation of expected value.
   c. The method of least squares.
   d. Matrix algebra.

18. A complex accounting computation involving many interdependent variables with seldom-changing reciprocal relationships can most efficiently be solved year after year by a properly programmed electronic computer through the use of
   a. Matrix algebra.
   b. Simultaneous linear equations.
   c. Successive interactions.
   d. Vector analysis.

19. If the cost of a proposed investment in machinery which is expected to produce equal annual cost savings for n years is equal to the annual savings multiplied by the present value of an annuity of one for n periods at i rate of interest, the present value of an annuity of one is also equal to

a. The present value of an annuity due of one for n—1 periods at i rate of interest, minus one.
b. The annual depreciation expense of the machine computed under the sinking fund method.
c. The payback period of the investment in the machine.
d. The compound amount of one, minus one, divided by the rate of interest.

20. Which of the following items should never be included in the current sections of the balance sheet?

a. Premium paid over face amount of bond investment.
b. Receivable from customer not collectible for over one year.
c. Deferred income taxes resulting from interperiod income tax allocation.
d. Funded serial bonds.

Number 2 (Estimated time—25 to 30 minutes)

To meet the need of its expanding operations Johnson Corporation obtained a charter for a separate corporation whose purpose was to buy a land site, build and equip a new building and lease the entire facility to Johnson Corporation for a period of 20 years. Rental to be paid by Johnson was set at an amount sufficient to cover expenses of operation and debt service on the corporation's 20 year serial mortgage bonds. During the term of the lease, the lessee has the option of purchasing the facilities at a price that will retire the bonds and cover the costs of liquidation of the corporation. Alternatively, at the termination of the lease, the properties will be transferred to Johnson for a small consideration. At the exercise of the option or at the termination of the lease, the lessor corporation will be dissolved.

Required:

a. Under certain conditions generally accepted accounting principles provide that leased property be included in the balance sheet of a lessee even though legal title remains with the lessor.

1. Discuss the conditions that would require financial statement recogninition of the asset and the related liability by a lessee.
2. Describe the accounting treatment that should be employed by a lessee under the conditions you described in your answer to part "a. 1."

b. Unless the conditions referred to in part "a" are present, generally accepted accounting principles do not embrace asset recognition of leases in the financial statements of lessees. However, some accountants do advocate recognition by lessees that have acquired "property rights." Explain what is meant by property rights and discuss the conditions under which these rights might be considered to have been acquired by a lessee.

c. Under the circumstances described in the case above, how should the Johnson Corporation account for the lease transactions in its financial statements? Explain your answer.

Number 3 (Estimated time—25 to 30 minutes)

The accounting profession, in the development and implementation of accounting principles, seeks to increase the usefulness of financial statements to their readers.

Required:

a. An authoritative accounting body recently recommended including in net income all items of profit and loss recognized in the period except prior period adjustments and capital transactions involving equity accounts, with extraordinary items shown separately as an element of net income of the period.

1. List the *advantages* of the recommendation.
2. List the *disadvantages* of the recommendation.

b. The recommendation specified in requirement "a" above is based on the premise that capital transactions should be distinguished from income.

1. Why should capital transactions be distinguished from income?
2. In what way does the income expected to be generated by an asset relate to its acquisition cost and valuation in financial statements? **Discuss.**

Number 4 (Estimated time—25 to 30 minutes)

On December 14, 1963, the board of directors of the Needleman Company authorized a grant of nontransferable (restricted) options to Company executives for the purchase of 10,000 shares of common stock at 52½ any time during 1966 if the executives still were employed by the Company. The closing price of Needleman common stock was 55 on December 14, 1963, 52 on January 2, 1966, and 49⅛ on December 31, 1966. None of the options were exercised.

Required:

a. Prepare a schedule presenting the computation of the compensation cost which should be attributed to the options of Needleman Company.

b. Assume that the market price of Needleman common stock rose to 57 (instead of declining to 52) on January 2, 1966, and that all options were exercised on that date. Would the Company incur a cost for executive compensation? *Why?*

c. Discuss the arguments for measuring compensation from executive stock options in terms of the spread between the

1. Market price and option price when the grant is made.
2. Market price and option price when the options are first exercisable.
3. Market price and option price when the options are exercised.
4. Cash value of the executives' services estimated at date of grant and the amount of their salaries.

Number 5 (Estimated time—25 to 30 minutes)

The following financial statement was prepared by employees of the Melhus Corporation.

Melhus Corporation

STATEMENT OF INCOME AND RETAINED EARNINGS

Years Ended December 31, 1966 and December 31, 1965

	1966	*1965*
Revenues:		
Gross sales, including sales taxes	$876,900	$782,500
Less returns, allowances and cash discounts	18,800	16,200
Net sales	858,100	766,300
Dividends, interest and purchases discounts	30,250	18,300
Recoveries of accounts written off in prior years	11,800	3,000
Gains on sale of treasury stock	2,050	
Total revenues	902,200	787,600
Costs and expenses:		
Cost of goods sold, including sales taxes	415,900	332,200
Salaries and related payroll expenses	60,500	62,100
Rent	19,100	19,100
Freight-in and freight-out	3,400	2,900
Bad debt expense	24,000	26,000
Addition to reserve for possible inventory losses	3,800	2,000
Total costs and expenses	526,700	444,300
Income before extraordinary items	375,500	343,300
Extraordinary items:		
Loss on discontinued styles (note 1)	24,000	4,800
Loss on sale of marketable securities (note 2)	52,050	
Loss on sale of warehouse (note 3)	86,350	
Retroactive settlement of federal income taxes for 1965 and 1964 (note 4)	31,600	
Total extraordinary items	194,000	4,800
Net income	181,500	338,500
Retained earnings at beginning of year	310,700	163,100
Total	492,200	501,600
Less: Federal income taxes	120,000	170,000
Cash dividends on common stock	21,900	20,900
Total	141,900	190,900
Retained earnings at end of year	$350,300	$310,700
Net income per share of common stock	$1.81	$3.38

Notes to the Statement of Income and Retained Earnings:

1. New styles and rapidly changing consumer preferences resulted in a $24,000 loss on the disposal of discontinued styles and related accessories.
2. The Corporation sold an investment in marketable securities at a loss of $52,050 with no income tax effect.
3. The Corporation sold one of its warehouses at an $86,350 loss.
4. The Corporation was charged $31,600 retroactively for additional income taxes resulting from a settlement in 1966. Of this amount $14,000 was applicable to 1965 and the balance was applicable to 1964.

Required:

Identify and discuss the weaknesses in classification and disclosure in the one-step Statement of Income and Retained Earnings above. Your discussion should explain why you consider these treatments to be weaknesses and what you consider to be the proper treatment of the items. Do **not** discuss form and terminology or prepare a revised statement. (You should assume that the arithmetic is correct.)

Number 6 (Estimated time—25 to 30 minutes)

The president of the D'Anna Company, a manufacturer, is concerned about your proposed qualification relating to material investments in marketable securities presented on its financial statements at the closing prices traded on the New York and American Stock Exchanges at December 31, 1966. The closing prices were substantially in excess of acquisition cost.

He stated, "... the thousands of transactions in shares of open-end investment trusts at prices reflecting current market values of their portfolios are evidence that most people view these value changes as equivalent to realization. Indeed, the cost of the investment is an incredibly low figure to present."

You explain that some transactions, events and changes in valuation are not recognized for accounting purposes under generally accepted accounting principles.

Required:

a. List types of transactions, events and changes in valuation that are **not** recognized for accounting purposes under generally accepted accounting principles.

b. 1. What should be considered in selecting the method of revenue recognition that is most appropriate for a particular situation? Do *not* list methods of revenue recognition.
   2. Discuss the appropriateness of D'Anna Company's proposal to recognize as revenue the excess of closing prices on the stock exchanges over the cost of the investment.

Number 7 (Estimated time—25 to 30 minutes)

Financial statements are tools for the communication of quantifiable economic information to readers who use them as one of the factors in making a variety of management and investment decisions and judgments. To fulfill this function accounting data should be quantifiable and should also be relevant to the kinds of judgments and decisions made. They should be verifiable and free from personal bias. There are many who believe that for some purposes current cost is a more useful measure than historical cost and recommend that dual statements be prepared showing both historical and current costs.

Required:

a. Discuss the ways in which historical costs and current costs conform to the standards of verifiability and freedom from bias.

b. Describe briefly how the current cost of the following assets might be determined.

1. Inventory
2. Investments in marketable securities
3. Equipment and machinery
4. Natural resources
5. Goodwill

c. While historical cost might be described as being objectively measurable, there is still an element of uncertainty in determining at any point in time the portion that has expired and should be expensed and the unexpired portion that should be carried as an asset. Explain how probability analysis might be employed in estimating the unexpired portion of research and development costs to be carried as an asset on the statement of financial condition.

Examination, May, 1968

EXAMINATION IN ACCOUNTING PRACTICE—PART I

May 15, 1968; 1:30 to 6:00 p.m.

All problems are required

Number 1 (Estimated time—50 to 60 minutes)

Thomas Ruskin engaged you to examine the financial statements for the year ended December 31, 1967 which he prepared as trustee for a testamentary trust established by the will of James Muriel for the benefit of Muriel's only daughter, Joan, and his nephew, Samuel, a minor child. The following is one of the statements Ruskin furnished to you:

James Muriel Trust
CASH RECEIPTS AND DISBURSEMENTS
For the Year Ended December 31, 1967

Receipts:		
Cash dividends from domestic corporations		$ 5,200
Interest from savings account		4,695
Net proceeds from sale of securities		30,725
Net proceeds from sale of land and building		67,500
Rent from building (sold July 1, 1967)		16,400
Rent from farm land		7,400
Royalties from patent		2,150
Total receipts		134,070
Disbursements:		
Office rent	$ 780	
Clerical salary	1,200	
Legal and accounting fees	1,005	
Insurance and bonding fees	220	
Miscellaneous office expenses	740	
Trustee's commission	1,435	
Building rental expenses:		
Repairs	235	
Real estate taxes (for year ended June 30, 1967)	2,250	
Utilities	2,680	
Insurance	1,425	
Janitor service	3,200	
Farm land rental expenses:		
Property management fees	600	
Real estate taxes	1,860	
Distributions to beneficiary	12,000	
Total disbursements		29,630
Increase in cash during 1967		$104,440

Your examination of the asset accounts and related records revealed the following:

Assets Sold	*Date Sold*	*Date Purchased*	*Sales Price*	*Expense of Sale*	*Net Proceeds*	*Purchase Cost*	*Value at 7/1/57 Date of Death*
Textile stock ...	3/17/67	1/6/67	$ 2,200	$ 25	$ 2,175	$ 1,900	
Western stock ..	4/27/67	9/6/53	12,000	100	11,900	14,500	$12,100
Power stock ...	6/26/67	5/2/56	16,800	150	16,650	13,500	13,700
Land and building	7/1/67	7/1/47	68,000	500	67,500	30,000	70,000

Estate taxes were paid on Muriel's estate as of the date of his death, July 1, 1957. The trust came into existence on the same date.

The land sold on July 1, 1967 was allocated $5,000 of the joint purchase cost of the land and building, $20,000 of the value at date of death, and $23,000 of the sales price. Muriel had depreciated the building under the straight-line method with a 50-year estimated life; depreciation until date of death totaled $5,000 and the estimated remaining useful life at that date was 40 years with no estimated salvage value. The trustee depreciated the building under the straight-line method.

A Radio Corporation bond became entirely worthless on February 1, 1967. It had been purchased by Muriel in 1956 for $250 and had a fair market value of $200 at the date of his death.

Uninsured lumber purchased and charged to an asset account by the Trust in December 1966 to be used in building repairs was destroyed by fire on January 3, 1967 when it had a fair market value and basis of $190.

Muriel had developed a pressing machine for which he received a patent June 30, 1955. At the date of death he was negotiating a contract to assign the use of the patent. Shortly after Muriel's death the trustee completed a contract which required the licensee to pay $2,150 per year over the 15-year remaining life of the patent. Muriel's cost to obtain the patent was $850 and it had a fair market value of $20,000 at the date of death with an estimated $5,000 renewal value.

The trust instrument included the following provisions:

1. The trustee has the power to sell or exchange trust assets. Gains or losses are allocable to corpus and corpus is to be retained intact. Depreciation and amortization are to be retained by the trust in a reserve as part of corpus.

2. Expenses of the trust are to be paid from income.

3. Three-fourths of the income remaining after payment of expenses of the trust is to be distributed currently to Joan Muriel. Prior to Samuel's twenty-first birthday the balance is to be accumulated for the benefit of Samuel and distributed to him at the discretion of the trustee. All income accumulated on Samuel's behalf is to be distributed to him at age 21. After Samuel's twenty-first birthday the balance is to be distributed to him currently.

4. The trustee is empowered to invade the corpus of the trust for the benefit of either beneficiary. Any remaining corpus and undistributed income shall be distributed pro rata between the two beneficiaries of the trust at its termination, provided they are then living. If neither beneficiary is then living any remaining corpus and undistributed income shall be distributed pro rata to all of Muriel's

then living blood relatives. The trust is to terminate 30 years after its creation or 21 years after both beneficiaries have deceased, whichever occurs first.

Required:

a. Prepare a schedule presenting the computation of the net gain taxable to the Trust from the disposal of assets.

b. Prepare a schedule of the computation of taxable income for the Trust for 1967. Begin your computation with the $104,440 amount listed in the financial statements as "Increase in cash during 1967." Supporting computations should be in good form. Assume that the Trust's distributable net income for 1967 amounted to $16,000.

c. Answer the following questions: (No computations are necessary.)
1. What tax rate schedule should be used to compute the Trust's federal income tax liability?
2. What effect, if any, would there have been on the Trust's taxable income if the Trust had received $10,000 interest income from municipal bonds in addition to the amounts stated in the problem? **Why?**

Number 2 (Estimated time—40 to 50 minutes)

Notil Industries, Inc. recently established the Mocon Division (not a separate corporation) to manufacture and market a new type computer. Notil's executive committee is considering various financing methods and requests that you make a profit-volume analysis and advise the committee of the probable results of several alternatives available.

Required:

a. Engineering estimates indicate that the variable cost of manufacturing a unit will be $20,000. It is estimated that the variable cost of selling a unit will be $10,000 if the sales price should be set at $50,000 per unit. State and federal income taxes are estimated at 55 per cent of net income before taxes (disregard the investment credit).

It is also estimated that Mocon will incur fixed costs totaling $4,000,000 per year including depreciation. Notil must secure an additional $10,000,000 to finance the Mocon Division. Notil plans to issue at par either stocks or bonds and Mocon must bear the financing cost in addition to other costs. Compute the number of units which must be sold annually at $50,000 per unit to pay all costs, meet any dividend requirement and comply with the stated objective under each of the following alternatives (show your computations):
1. 6% nonparticipating, cumulative, preferred stock is issued.
2. 5% bonds are issued.
3. 5% bonds are issued and Notil requires that Mocon contribute 6 per cent of its sales to be credited to Notil Industries' retained earnings for internal financing and future expansion.

4. 5% bonds are issued and Notil requires that Mocon contribute annually both $100,000 to be paid out as dividends to Notil's common stockholders and 6 per cent of Mocon's sales to be credited to Notil's retained earnings for internal financing and future expansion.

b. Mocon will have 72 salesmen. Market surveys indicate that each salesman should sell an average of one unit every three months if the sales price of the computer is set at $50,000 per unit and that no salesman is likely to sell more than one unit in any month.

Compute the following (show your computations):

1. The probability that any individual salesman will sell a computer in any one month.
2. The average number of units that Mocon can expect to sell per month at $50,000.

c. The market surveys also indicated that each salesman should be expected to sell one unit every four months if the sales price should be set at $60,000 per unit. Reduced sales would cause the variable cost of selling a unit to increase to $12,000. Notil's executive committee requests that you

1. Recompute requirement "a.4." under this alternative.
2. Advise them whether to set the sales price at $50,000 or $60,000. Explain why the sales price should be set at the amount you recommend.

Number 3 (Estimated time—40 to 50 minutes)

Copra Trading Company established a foreign Branch Office on Arpoc Cay in 1960 to purchase local products for resale by the Home Office and to sell Company products.

You were engaged to examine the Company's financial statements for the year ended December 31, 1967 and engaged a chartered professional accountant in Arpoc to examine the Branch Office accounts. He reported that the Branch accounts were fairly stated in pesos, the local currency, except a franchise fee and any possible adjustments required by Home Office accounting procedures were not recorded. Trial balances for both the Branch Office and Home Office appear on page 5.

Your examination disclosed the following information:

1. The peso was devalued July 1, 1967 from 4 pesos per $1 to 5 pesos per $1. The former rate of exchange had been in effect since 1959.

2. A billing of $4,000 was included in the Branch Current Account covering a shipment of merchandise made on December 29, 1967 which was not received or recorded by the Branch in 1967. Sales to the Branch are marked up 33-1/3 per cent and shipped F.O.B. Home Office. Branch sales to Home Office are made at Branch cost.

3. The Branch had a beginning and ending inventory on hand valued at 80,000 pesos of which one-half at each date had been purchased from the Home Office. The Home Office had an inventory at December 31, 1967 valued at $520,000.

4. The Investment in Branch is the unamortized portion of a $15,000 fee

Copra Trading Company and Branch Office
TRIAL BALANCES
At December 31, 1967

Debits	*Branch Office Trial Balance (In pesos)*	*Home Office Trial Balance (In dollars)*
Cash	110,000	$ 90,000
Trade accounts receivable	140,000	160,000
Branch current account		10,000
Inventory	80,000*	510,000*
Prepaid expenses	10,000	18,000
Fixed assets	1,000,000	750,000
Investment in Branch		12,000
Purchases	1,180,000	3,010,000
Purchases from Branch		140,000
Operating and general expenses	190,000	680,000
Depreciation expense	100,000	50,000
Total debits	2,810,000	$5,430,000
Credits		
Allowance for depreciation	650,000	$ 350,000
Current liabilities	220,000	240,000
Home Office current account	30,000	
Long-term indebtedness	230,000	200,000
Capital stock		300,000
Retained earnings		145,000*
Sales	1,680,000	4,035,000
Sales to Branch		160,000
Total credits	2,810,000	$5,430,000

* at January 1, 1967

paid in January 1966 to a U. S. firm for marketing research for the Branch. Currency restrictions prevented the Branch from paying the fee, which was paid by the Home Office. The Home Office agreed to take merchandise in repayment over a 5-year period during which the fee is to be amortized.

5. The Branch incurred its long-term indebtedness in 1962 to finance its most recent purchase of fixed assets.

6. The Government of Arpoc imposes a franchise fee of 10 pesos per 100 pesos of net income of the Branch in exchange for certain exclusive trading rights granted. The fee is payable each May 1 for the preceding calendar year's trading rights and had not been recorded by the Branch at December 31.

Required:

Prepare a worksheet to present the combined income statement and combined balance sheet of Copra Trading Company and its foreign Branch Office with all amounts stated in U. S. dollars. Formal statements and journal entries are not required. Supporting computations must be in good form. Number the worksheet adjusting and eliminating entries.

Number 4 (Estimated time—40 to 50 minutes)

You have completed your examination of the cash on hand and in banks in your audit of the Hoosier Company's financial statements for the year ended December 31, 1967 and noted the following:

1. The Company maintains a general bank account at The National Bank and an imprest payroll bank account at The City Bank. All checks are signed by the Company president, Douglas Hoosier.

2. Data and reconciliations prepared by Donald Hume, the Company bookkeeper, at November 30, 1967 indicated that the payroll account had a $1,000 general ledger and bank balance with no in-transit or outstanding items, and the general bank account had a $12,405 general ledger balance with checks outstanding aggregating $918 (No. 1202 for $575 and No. 1205 for $343) and one deposit of $492 in transit.

3. Your surprise cash count on Tuesday, January 2, 1968 revealed customers' checks totaling $540 and a National Bank deposit slip for that amount dated December 29, 1967 were in the Company safe and that no cash was in transit to the bank at that time. Your examination of the general account check book revealed check No. 1216 to be the first unused check.

4. Company general ledger accounts are prepared on a posting machine and all transactions are posted in chronological sequence. The ledger card for the general bank account is reproduced on page 220.

5. The December statements from both banks were delivered unopened to you. The City Bank statement contained deposits for $1,675; $1,706; $1,845; and $2,597 and 72 paid checks totaling $7,823. The National Bank statement is reproduced below:

THE NATIONAL BANK

Account: Hoosier Company (General Account)

Date	*Charges*		*Credits*	*Balance*
Nov 30				12,831
Dec 1			492	13,323
Dec 5	1,675	267 RT	496	11,877
Dec 8	575		832	12,134
Dec 11	1,706	654	975	10,749
Dec 14	1,987 D	2,062	8,045	14,745
Dec 18	6,237	1,845	9,949	16,612
Dec 21	241 RT	546 RT	546 CM	16,371
Dec 22	2,072 D		1,513	15,812
Dec 26	2,597			13,215
Dec 28	362	4 DM	1,010 CM	13,859
Dec 29	12 DM		362	14,209
	Total charges—$22,842		Tot. Cr.—$24,220	

Legend: OD: Overdraft RT: Returned check DM: Debit memo
CM: Credit memo D: Draft

GENERAL LEDGER
GENERAL BANK ACCOUNT
(The National Bank)

Ref.	*Debits*	*Credits*	*Balance*
Bal.			12,405
12-1	496		12,901
1206		1,675	11,226
1207		645	10,581
12-6	832		11,413
1208		1,706	9,707
12-8	975		10,682
1209		2,062	8,620
1210		3,945	4,675
1211		6,237	1,562*
12-12	8,045		6,483
12-15	9,549		16,032
1212		1,845	14,187
RT		241	13,946
1213		350	13,596
D		2,072	11,524
12-22	1,513		13,037
1214		2,597	10,440
1215		1,739	8,701
12-29	540		9,241
12-31	942		10,183
1216		1,120	9,063
	22,892	26,234	

6. Cutoff statements were secured by you personally from both banks on January 8, 1968 and The National Bank statement is reproduced below:

THE NATIONAL BANK
Account: Hoosier Company (General Account)

Date	*Charges*		*Credits*	*Balance*
Dec 29, 1967				14,209
Jan 2, 1968	1,739	3,945	540	9,065
Jan 5	350		942	9,657

7. You determine that the bank statements are correct except that The National Bank incorrectly charged a returned check on December 21 but credited the account the same day.

8. The $362 check charged by The National Bank on December 28 was check No. 2000 drawn payable to Hoosier Company and indorsed "Hoosier Company by Donald Hume." Your investigation showed that the amount credited by The National Bank on December 29 was an unauthorized transfer from The City Bank Payroll Account to The National Bank General Account which had been made by the Company's bookkeeper who made no related entry in the Company's records. The check was charged to Hoosier Company on January 2, 1968 on the cutoff statement received by you from The City Bank.

9. Drafts charged against The National Bank account were for trade acceptances which were signed by Douglas Hoosier and issued to a supplier.

10. On December 28 a 60-day 6 per cent $1,000 note was collected by The National Bank for Hoosier for a $4 collection fee.

11. The $12 debit memo from The National Bank was a charge for printed checks.

12. Check No. 1213 was issued to replace check No. 1205 when the latter was reported not received by a vendor. Because of the delay in paying this account Hoosier Company was no longer entitled to the 2 per cent cash discount it had taken in preparing the original check.

Required:

Prepare a proof of cash for December for Hoosier's General Bank Account in The National Bank. Your proof of cash should show the computation of the adjusted balances for both the bank statement and the general ledger account of The National Bank for cash in bank November 30, December receipts, December disbursements and cash in bank December 31. The following column headings are recommended:

Description	*November 30 Reconciliation*	*December Receipts*	*December Disbursements*	*December 31 Reconciliation*

Number 5 (Estimated time—50 to 60 minutes)

You rendered an auditor's unqualified opinion on the financial statements on page 222.

At the completion of your examination of the financial statements of Wood Products Company you were engaged to recommend specific additional insurance coverage. Your examination disclosed that the Company carried adequate insurance except that no business interruption insurance was carried.

The following provisions appear in the insurance policy you recommend:

1. *Recovery:*

   Recovery in the event of loss hereunder shall be the Actual Loss Sustained during a defined period by the Insured directly resulting from such interruption of business, but not exceeding the reduction in gross earnings less charges and expenses which do not continue during the interruption of business. The defined period is the length of time which would be required with the exercise of due diligence and dispatch to rebuild, repair or replace such part of the property herein described as has been damaged or destroyed, commencing with the date of such damage or destruction and not limited by the date of expiration of this policy.

Wood Products Company

STATEMENT OF INCOME
For the Year Ended December 31, 1967

Sales		$292,560
Cost of goods sold		249,750
Gross profit		42,810
Selling, general and administrative expenses:		
Freight out	$4,530	
Sales commissions	340	
Sales discounts	4,070	
Bad debts	330	
Automobile and truck expenses	3,550	
General expense	2,550	
Office expense	1,020	
Office and executive salaries	16,550	
Total selling, general and administrative expenses		32,940
Operating income		9,870
Other income:		
Purchase discounts	3,410	
Rental income	980	
Interest on U. S. Government bonds	400	4,790
Income before income taxes		14,660
Federal and state income taxes		4,560
Net income		$10,100

STATEMENT OF COST OF GOODS SOLD
For the Year Ended December 31, 1967

Raw materials used		$189,730
Factory labor		47,560
Factory overhead:		
Payroll taxes	$1,470	
Heat, light and power	2,870	
Repairs	1,240	
Depreciation—machinery and building	3,590	
Superintendent's salary	9,120	
Miscellaneous factory expenses	10,090	28,380
Total factory costs		265,670
Less increase in work-in-process inventory		2,170
Cost of goods manufactured		263,500
Less increase in finished goods inventory		13,750
Cost of goods sold		$249,750

2. *Gross Earnings:*
For the purposes of this insurance "Gross Earnings" are defined as:
(a) The sum of:
(i) Net sales value (sales value less outside sales expenses) of total production,
(ii) Net sales value of total merchandise purchased for resale and
(iii) Other earnings derived from operation of the business.
(b) Less the cost of:
(i) Raw stock from which such production is derived,
(ii) Merchandise sold, including packaging materials therefor,
(iii) Materials and supplies consumed directly in goods or service(s) sold and
(iv) Service(s) purchased from outsiders (not employees of the Insured) for resale.

No other costs shall be deducted in determining "Gross Earnings."

3. *Contribution Clause:*
In consideration of the rate and form under which this policy is written this Company shall be liable in the event of loss for no greater proportion thereof than the amount covered bears to __ per cent (insert 50, 60, 70, 80, 90, or 100) of the gross earnings that would have been earned (had no loss occurred) during the 12 months immediately following the date of damage to or destruction of the described property.

Additional information was obtained through discussions with management and reviews of the profit and loss accounts, sales orders and your audit working papers:

1. Payments for freight out and sales commissions are for services performed by outsiders who are not employees.

2. It is anticipated that production and sales in 1968 will be maintained at the same level as 1967 and that costs and sales prices will not change.

3. Sales discounts and bad debts are considered selling expenses. Automobile and truck expenses are considered general and administrative expenses.

4. Although production is even throughout the year 60 per cent of the sales orders are received and shipped during the months of May through September with the balance spread evenly throughout the remainder of the year.

5. The factory labor force is highly skilled and under a guaranteed annual contract. All employees will be kept on the payroll during any period when the plant is not operating.

6. The Company has signed contracts for heat, light and power providing for minimum monthly payments totaling $100 per month.

7. "Miscellaneous factory expenses" are about 65 per cent variable.

8. General and administrative expenses would not be likely to decrease during an extended shutdown resulting from a fire unless the Company decided not to rebuild and resume operations.

9. Rental income is received for a portion of the factory building not presently needed for the Company's own operations.

10. In case of the complete destruction of the plant a maximum period of eight months would be required to rebuild and re-equip the plant to replace the raw material and work-in-process inventories.

Required:

a. Prepare a schedule computing defined gross earnings estimated for 1968 based on the provisions of the insurance policy. You should separately identify the components of net sales value, cost of sales, gross earnings from manufacturing, and defined gross earnings.

b. Assume that the "defined gross earnings" for 1968 are estimated to be $120,000. Also assume that it is estimated that $10,000 in expenses could be discontinued during a maximum loss period. Prepare a schedule computing

1. The amount of business interruption insurance you would recommend that Wood Products Company carry and
2. The co-insurance clause (rate) that you would recommend.

c. Prepare a schedule computing the estimated amount of "heat, light and power" expense and "miscellaneous factory expenses" that could be discontinued during a maximum loss period.

d. What recommendations might you make regarding other insurance coverage in light of the fact that an abnormal fluctuation of inventories on hand is to be expected?

EXAMINATION IN ACCOUNTING PRACTICE—PART II

May 16, 1968; 1:30 to 6:00 p.m.

GROUP I

Solve all problems in this group.

Number 1 (Estimated time—40 to 50 minutes)

Instructions

Each of the following unrelated numbered statements gives a conclusion in relation to the lettered fact situation. You are to determine whether each of the statements is true or false according to the provisions of the *Internal Revenue Code* and *Tax Regulations*. On a separate answer sheet write whether each statement is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

An example of the manner in which the question should be marked is shown in the following illustration:

Facts

X. John Jones, age 27, is married and provides the sole support for his wife, age 24, and two small children. During 1967 Jones earned $9,000 and received $100 interest from municipal bonds as his only income.

Questions

1. Jones may claim four personal exemptions on a joint return.
2. Jones must report $9,100 income on his tax return.
3. Jones may claim a standard deduction of $900.

Answer Sheet

1. True
2. False
3. True

Questions to be Answered

Facts

A. The following information is available for the dates indicated in 1967:

January 5	Atkins purchased 100 shares of Ritz Corporation common stock for $150 per share.
July 3	Ritz Corporation paid a 50 per cent stock dividend in common stock to all common stockholders. The stock received by Atkins had a fair market value of $100 per share. The stock dividend was not in discharge of preference dividends and no stockholder had an option to receive cash or other property in lieu of stock.
July 7	Atkins traded his original 100 shares to Busby for Busby's only personal residence. Busby, a bachelor who decided to live in rented premises, had purchased his former residence May 7, 1963 for $9,500 and had spent $1,000 two weeks prior to the trade for painting and repairs on the house to get it ready to sell. The fair market value of Ritz common was $125 per share.
October 2	Ritz Corporation paid a dividend of one share of Whity Corporation common stock for each share of Ritz common outstanding and issued stock warrants giving each Ritz common stockholder the right for six months to purchase one share of Ritz Corporation preferred stock for each share of Ritz common stock owned. The warrants were not in discharge of preference dividends and no stockholder had the option to receive cash or other property in lieu of the warrants. The fair market values were $90 per share for Ritz common stock, $10 per share for Whity common stock (which had a par value of $5 per share), and $30 per Ritz preferred warrant.
November 3	Atkins exercised all of his warrants and paid $50 for each share of Ritz preferred stock that he purchased.
December 29	Atkins sold all of his Ritz common for $100 per share and all of his Ritz preferred at $90 per share.
December 31	Busby still owned all of the securities he had received.

Questions

1. The shares of stock received by Atkins on July 3, 1967 had a tax basis to him of $5,000 and a date basis of July 3, 1967.
2. The exchange of the stock for the residence on July 7, 1967 resulted in a long-term capital gain of $2,500 to Atkins.
3. Atkins' tax basis for the residence is $12,500 and his date basis is July 7, 1967.
4. Busby is entitled to an itemized deduction of $1,000 for the painting and repairs on his residence.

5. Busby received gross taxable dividends in the amount of $1,000 on October 2, 1967.
6. Busby's tax basis at December 31, 1967 for the Ritz Corporation common stock he owned was $10,500 and his date basis was July 7, 1967.
7. Busby can elect a zero tax basis for the warrants he owned at December 31, 1967.
8. The sale of the Ritz common stock on December 29, 1967 resulted in a $1,250 long-term capital gain to Atkins.
9. The sale of the Ritz preferred stock on December 29, 1967 resulted in a short-term capital gain of $10 per share to Atkins.
10. Atkins' tax basis for his Whity common stock is $500 and his date basis is October 2, 1967.

Facts

B. Dana purchased a lot on July 5, 1964 for $50,000. On December 30, 1966 Dana received authorization from the state to charter Exter Corporation. The charter stated that the Corporation was being organized to construct and sell a building. The following information is available for the dates indicated in 1967:

January 2	Dana personally mortgaged the lot for $75,000 and then transferred the lot and the mortgage to Exter Corporation solely in exchange for all of Exter's stock (1,000 shares at a stated value of $100 per share). Dana became president and chairman of the board of directors of Exter Corporation. Exter Corporation assumed the mortgage.
June 30	Exter Corporation completed construction of a building on the lot at a cost of $200,000 under a construction loan for the full amount.
July 3	Freeman, a real-estate dealer, loaned Exter Corporation $300,000 and Exter paid the $75,000 mortgage, the $200,000 construction loan, and $10,000 interest. Freeman agreed to accept the lot at $75,000 and the building at $225,000 in cancellation of his note. Exter Corporation made the transfer, distributed the $15,000 remaining cash to Dana in exchange for his stock, and was dissolved. Freeman allocated $135,000 of the cost of the building to first-floor store space which he rented, $56,250 to two second-story apartments which he rented, and $33,750 to a second-story apartment which he used as his personal residence and to which he moved from an apartment he occupied as a tenant.
December 17	The building was completely destroyed by fire.
December 27	Freeman exchanged the lot for $35,000 cash and a $45,000 house into which he moved as his personal residence.
December 29	Freeman received a check in the amount of $230,000 from an insurance company in full settlement of his claim.

Questions

11. Dana's transfer of the lot to Exter Corporation in exchange for Exter stock was a tax-free exchange to Dana.
12. Exter Corporation's tax basis of the lot was $75,000.
13. Exter Corporation must report a $25,000 long-term capital gain from the transfer of the land and building to Freeman on July 3, 1967.
14. Dana may not elect to treat Exter Corporation as a small business corporation under the provisions of Subchapter S when preparing Exter's 1967 income tax return.
15. Only 95 per cent of the depreciation deduction claimed by Freeman would be recaptured as ordinary gain under the provisions of Section 1250.
16. Any gain reported by Freeman from the exchange of the lot on December 27, 1967 will be ordinary gain.
17. Freeman may elect to defer the recognition of gain from the exchange of the lot on December 27.
18. Freeman's tax basis of the house received in the exchange on December 27, 1967 is $45,000.
19. Freeman may elect not to report any gain in 1967 from the insurance proceeds received for the building space allocated to the store and rental apartments.
20. Assuming that Freeman does not claim a deduction in 1967 for depreciation of the building space allocated to the store and rental apartments, any gain reported from the insurance proceeds for this space will be long-term capital gain if he has no losses from property described by Section 1231.

Number 2 (Estimated time—40 to 50 minutes)

Kaerwer Corporation operates a machine shop and employs an estimated cost system. In March 1968 Kaerwer was low bidder on a contract to deliver 600 kartz by May 15 at a contract price of $200 each. Kaerwer's estimate of the costs to manufacture each kartz was:

40 pounds of materials at $1.50 per pound	$ 60
20 hours of direct labor at $2.00 per hour	40
Manufacturing overhead (40% variable)	30
Total cost	$130

Inventories on hand at April 1 included 30 completed kartz which had not been transferred to finished goods inventory, 70 kartz 60 per cent processed, and 2,000 pounds of materials at a cost of $3,000. Production during March was at estimated costs. During April 500 kartz were started in production, 450 kartz were completed, and 480 kartz were transferred to finished goods. The work-in-process inventory at April 30 was 10 per cent processed. All material was added when a kartz was started in production. The materials inventory is priced under the FIFO method at actual cost.

The following information is available for the month of April:

1. Materials purchased:

Pounds	Amount
8,000	$12,000
8,000	12,800
4,000	5,600

2. Materials requisitioned and put into production totaled 21,000 pounds.
3. The direct labor payroll amounted to $18,648 for 8,880 hours.
4. Manufacturing overhead was applied on the basis of estimated direct labor hours. Actual manufacturing overhead incurred, including indirect labor, totaled $13,140 and was charged to the Overhead-in-process account.
5. Accounts employed by Kaerwer include Material-in-process, Labor-in-process, Overhead-in-process, Work-in-process Inventory, Finished Goods Inventory and Materials Inventory. The first three accounts are closed monthly. Perpetual inventory systems are maintained for materials and finished goods inventories.

Required:

a. Prepare in good form:

1. A quantity of production report which accounts for both actual units in production and equivalent unit production for materials and for labor and overhead for April.

2. A schedule presenting the computation of the balances (before closing) of the following accounts:

Materials inventory
Materials-in-process
Labor-in-process
Overhead-in-process
Work-in-process inventory
Finished goods inventory

b. Kaerwer Corporation would like to install a standard cost system and requests that you prepare a schedule presenting a computation of an analysis of the material, labor and overhead variances they could expect from such a system for production during April. Assume that the standard cost of a kartz would have been the same as the estimated cost of a kartz. Overhead variances should be divided into controllable and noncontrollable components assuming a standard normal capacity of 400 kartz per month.

Number 3 (Estimated time—40 to 50 minutes)

Amex Copper Company made an initial purchase of 10,000 shares of Wixon Mining Company common stock at $50 per share on January 2, 1966 and purchased an additional 12,500 shares on September 15 at $60 per share. All of the shares were purchased as long-term investments.

On November 30 Amex sold 2,500 shares at $72 per share from the second block of shares purchased.

Amex received regular cash dividends of $1 per share on April 1, July 1, and

October 1. The dividends were declared by Wixon on the tenth day of the previous month payable to stockholders of record as of the twentieth day of the month.

In addition Amex received a $1 per share cash dividend on December 21 paid by Wixon as the amount per share added to the Allowance for Depletion account during 1966. Amex also received a $7 per share special cash dividend from Wixon on December 31.

On December 31, 1966 Amex's trial balance reported a $1,000,000 balance in the Investment in Wixon Mining Company account and $202,500 dividend income from Wixon during 1966. Wixon Mining Company reported net earnings of $6 per share earned at a constant rate during 1966. Both Amex and Wixon prepare financial statements on a calendar-year basis.

On May 1, 1967 Amex exchanged 25,000 shares of Amex common stock held as treasury stock for 50,000 outstanding shares of Wixon Mining Company common stock and merged Wixon into Amex under a pooling of interests. Amex common stock was selling for $160 per share and Wixon common stock was selling for $80 per share immediately before the exchange. The capital accounts of the two companies appeared in their respective balance sheets at April 30, 1967 as presented below:

	Amex Copper Company		*Wixon Mining Company*	
Stockholders' Equity:				
Common stock:				
$100 par value (authorized 70,000 shares; issued 60,000 shares, of which 25,000 shares are in treasury)		$6,000,000		
$50 par value (authorized, issued and outstanding—50,000 shares)				$2,500,000
Contributed capital in excess of par value		930,000		60,000
Retained earnings at December 31, 1966	$750,000		$150,000	
Add net income through April 30, 1967	125,000		100,000	
Total	875,000		250,000	
Less dividends paid through April 30, 1967	70,000		50,000	
Retained earnings at April 30, 1967		805,000		200,000
Total		7,735,000		2,760,000
Less treasury stock—25,000 shares carried at acquisition cost		2,250,000		
Total stockholders' equity		$5,485,000		$2,760,000

Required:

a. Prepare the general journal entry that Amex should have recorded for the sale of the Wixon Mining Company stock at November 30, 1966.

b. Prepare a schedule computing the correct balance in Amex's Investment in Wixon Mining Company account at December 31, 1966.

c. Without regard to your solution in part "b" assume that Amex's Investment in Wixon Mining Company account had a correct balance of $1,050,000 for the 20,000 shares owned at April 30, 1967. Prepare the Stockholders' Equity section of the Amex Copper Company balance sheet at May 1, 1967 as it should appear after the merger was consummated and the Wixon stock retired. Supporting computations should be in good form. Footnotes are not required.

Number 4 (Estimated time—50 to 60 minutes)

You have been engaged by the Charlton Corporation since the fall of 1966 to translate the Corporation's financial statements from historical costs to current or replacement costs for internal use. You assisted in the determination at December 31, 1966 and 1967 of the amounts listed in the "Replacement Costs" columns on the statement of financial condition on page 232.

One of the factors considered in determining replacement costs was an increase in the price level, which at December 31, 1967 was 104 per cent of the price-level index at December 31, 1966. Management has now engaged you to translate Charlton Corporation's 1967 income statement from historical costs as it appears on page 233 to current costs.

The following information relative to current cost computations is also available:

1. The general price level increased early in January 1967 to 104 per cent of the 1966 price level. (For simplicity you may assume that both general and specific price changes apply to the entire year unless stated otherwise in the information given.)
2. The marketable securities were sold August 17, 1967 for $29,000.
3. Prepaid expenses are for prepaid variable manufacturing costs.
4. Land purchased in 1960 for $5,000 was sold November 20, 1967 for $12,000. The land had a replacement cost of $10,500 at December 31, 1966.
5. Replacement costs of the land and the plant and equipment increased by amounts greater than the increase in the general price level. Depreciation on plant and equipment is computed by the straight-line method at 5 per cent of the 1967 replacement cost. The allowance for depreciation was increased by depreciation for 1967 plus an adjustment for prior years based on 1967 replacement cost of the plant and equipment.
6. Depreciation is allocated 80 per cent to manufacturing operations and 10 per cent each to fixed selling expenses and fixed administrative expenses and is included in the fixed selling and administrative expenses on the income statement.

Charlton Corporation
STATEMENT OF FINANCIAL CONDITION
December 31, 1966 and 1967

	Historical Costs		*Replacement Costs*	
	1966	*1967*	*1966*	*1967*
Assets				
Current Assets:				
Cash	$ 238,500	$ 494,500	$ 238,500	$ 494,500
Receivables—net	581,500	760,850	581,500	760,850
Marketable securities	27,500		28,600	
Inventories	407,000	434,500	440,000	462,000
Prepaid expenses	5,500	11,000	5,500	11,000
Total current assets	1,260,000	1,700,850	1,294,100	1,728,350
Investment in Affiliated Company	440,000	440,000	660,000	726,000
Long-Term Assets:				
Land	110,000	105,000	231,000	231,000
Plant and equipment	3,850,000	3,850,000	5,390,000	5,713,400
Allowance for depreciation	(1,925,000)	(2,117,500)	(2,695,000)	(3,142,370)
Long-term lease	540,000	480,000	567,000	529,200
Total long-term assets	2,575,000	2,317,500	3,493,000	3,331,230
Patents—net	395,000	345,000	495,000	440,000
Total assets	$4,670,000	$4,803,350	$5,942,100	$6,225,580
Equities				
Current Liabilities:				
Accounts payable	$ 805,000	$ 709,400	$ 805,000	$ 709,400
Current portion of lease obligation	44,400	47,050	44,400	47,050
Total current liabilities	849,400	756,450	849,400	756,450
Long-Term Liabilities:				
5% bonds payable, due 1976	1,100,000	1,100,000	1,019,039	1,025,181
Lease obligation	465,600	418,550	465,600	418,550
Deferred income taxes payable	55,000	60,000	55,000	60,000
Estimated taxes on increases to replacement costs			591,005	645,524
Total long-term liabilities	1,620,600	1,578,550	2,130,644	2,149,255
Stockholders' Equity:				
Common stock—$100 par value	1,650,000	1,650,000		
Paid-in capital in excess of par	330,000	330,000		
Retained earnings	220,000	488,350		
Total stockholders' equity	2,200,000	2,468,350	2,962,056	3,319,875
Total equities	$4,670,000	$4,803,350	$5,942,100	$6,225,580

Charlton Corporation

STATEMENT OF INCOME FROM TRANSACTIONS
For The Year Ended December 31, 1967

	Historical Costs	
Sales		$7,999,750
Cost of Goods Sold:		
Inventories, December 31, 1966	$ 407,000	
Variable manufacturing costs	2,175,250	
Fixed manufacturing costs	825,000	
Depreciation	154,000	
Amortization of lease	60,000	
Amortization of patents	50,000	
Total	3,671,250	
Inventories, December 31, 1967	434,500	3,236,750
Gross margin		4,763,000
Operating Expenses:		
Variable selling expenses	1,375,000	
Fixed selling expenses	825,000	
Variable administrative expenses	275,000	
Fixed administrative expenses	1,650,000	4,125,000
Income from operations		638,000
Other Revenues, Gains and (Expenses):		
Dividends received	8,350	
Bond interest expense	(55,000)	
Lease interest expense	(27,950)	
Gain or (loss) from sale of securities	1,500	
Gain from sale of land	7,000	(66,100)
Income from transactions		571,900
Less income taxes		279,150
Net income from transactions		$ 292,750

7. The long-term lease is for the use of manufacturing facilities during the period 1966 through 1975. The lease required the payment of $90,000 on January 1, 1966 and $75,000 on each January 1 through 1975. Charlton capitalized the lease at $600,000 and is amortizing it on a straight-line basis. The replacement cost for a comparable unexpired lease increased 5 per cent each year for 1966 and 1967.

8. The replacement cost of patents increased a total of $15,000 in 1967 and amortization amounted to $70,000 on a replacement cost basis.

9. The 5 per cent bonds were originally issued at par and are due December 31, 1976. At December 31, 1966 and December 31, 1967 these bonds were selling in the market to yield 6 per cent interest. Interest is payable annually on December 31.

10. The deferred income taxes payable result from differences in treatment of items for income tax and financial reporting purposes. Management would like to have income taxes in the current costs section of the income statement based on historical costs expressed in current dollars.

Required:

Prepare a statement of income from transactions which expresses all amounts in current costs and determines net income from transactions. Supporting schedules should be in good form. (In addition to income from transactions Charlton Corporation would also recognize gains from current cost valuations and from purchasing power gains on net debt on its current cost income statement, but these computations are not required.)

GROUP II

Estimated time—50 to 60 minutes.

Solve one of the two problems in this group. If both are solved, only the first will be considered.

Number 5

Instructions

The following instructions pertain to problem number 5.

On a separate answer sheet write the letter of your answer choice for each of the following questions. Select only one answer for each question. Your grade will be determined from your total score of correct answers.

An example of the manner in which the answer sheet should be marked is shown in the following illustration:

Question

XX. Jones is to receive a bonus of 10 per cent of the $10,000 net income of a store he manages. The store must pay income tax on the balance of the net income after deducting Jones' bonus. If the income tax rate is 40 per cent, the store's income tax will amount to

a. $4,000.
b. $3,600.
c. $ 400.
d. $ 360.

Answer Sheet

XX. b.

Facts

You are the auditor in charge of the examination of the financial statements of the Williams Company for the year ended December 31, 1967. You were assigned to this engagement because the auditor who was in charge of the examination of the 1966 financial statements of the Williams Company is no longer associated with your accounting firm.

In the course of your examination you learn that the president of the Williams Company has a profit-sharing agreement with the Company which states that he is to receive a bonus composed of a basic amount plus the Company's tax saving on his total bonus. The basic amount of the bonus will be 10 per cent of the Company's net income (computed without regard to the bonus) after federal and state income taxes. In addition the basic bonus will be increased by the Company's tax saving because the total amount of the bonus is deductible in computing the Company's taxable income. (The tax saving is the difference between the federal and state income taxes the Company would have paid if there were no bonus and the taxes the Company must pay after deducting the bonus.)

Williams Company had a net income of $90,000 in 1966 before deduction of the president's bonus or the federal or state income taxes. The following information was included in the auditor's working papers for the computation of the bonus for 1966 with a computer print-out of the inverse matrix:

Computation of President's Bonus for 1966 by Matrix Algebra

In matrix notation let $AX = B$
and $X = A^{-1} B$
where X is the solution vector,
A^{-1} is the inverse of the coefficient matrix A,
and B is the vector of constants.
$X = A^{-1} B$ is expressed in matrix inverse form as follows:

$$\begin{bmatrix} B \\ S \\ F \\ T \\ I \end{bmatrix} = \begin{bmatrix} \frac{400}{169} & \frac{-20}{169} & \frac{-40}{169} & \frac{400}{169} & \frac{19}{169} \\ \frac{-20}{169} & \frac{170}{169} & \frac{2}{169} & \frac{-20}{169} & \frac{15}{338} \\ \frac{-190}{169} & \frac{-75}{169} & \frac{188}{169} & \frac{-190}{169} & \frac{285}{676} \\ \frac{210}{169} & \frac{-21}{338} & \frac{-21}{169} & \frac{379}{169} & \frac{399}{6760} \\ 0 & 0 & 0 & 0 & \frac{169}{169} \end{bmatrix} = \begin{bmatrix} \$\ 0 \\ \$\ 0 \\ \$\ 0 \\ \$\ 0 \\ \$90{,}000 \end{bmatrix}$$

with the letters designating the following:
B = total bonus due the president,
S = state income tax,
F = federal income tax,
T = total tax saving from president's bonus (to be added to the basic bonus),
I = net income before bonus and income taxes.

Assume that the state income tax rate for 1966 and 1967 is 5 per cent of net income after deducting the president's bonus (the federal income tax is not deductible in computing state income tax), the federal income tax rate for 1966 and 1967 is 50 per cent of net income after deducting both the president's bonus and the state income tax, and the net income for 1967 is $100,000 before deducting the president's bonus or the state and federal income taxes.

Required:

A. Based on the above information select the correct answer for each of the following statements:

1. A "trial and error" method which could be used to determine the bonus, income taxes, and net income is known as the
   a. Reverse computation method.
   b. Matrix multiplication method.
   c. Successive interaction method.
   d. Simultaneous equation method.

2. The unknown amounts could be determined through the use of simultaneous linear equations by employing
   a. Reverse subtraction with increasing constraints.
   b. Addition of elements with division by constants.
   c. Multiplication of constants by curvilinear inequations.
   d. Variable elimination through substitution.

3. The matrix A^{-1} is the unique inverse of the matrix A. Multiplication of the matrix A^{-1} by the matrix A will produce
   a. An identity matrix.
   b. A reverse coefficient matrix.
   c. A dual solution vector.
   d. A primal vector.

4. The process of matrix inversion of the matrix A can be accomplished by
   a. Row operations on the tableau $(A|I)$ if I is an identity matrix of the same order as A.
   b. Transposing the matrix A.
   c. Multiplication of the matrix A by a scalar k if k is a real number.
   d. Multiplication of the matrix A by a product matrix C.

5. If $A^{-1} A = AA^{-1}$ the matrix A must be
   a. A matrix of the order m by n where $m \neq n$.
   b. A non-zero square matrix of the order m by n where m denotes rows and n denotes columns.
   c. The transpose of the matrix A^{-1}.
   d. Multiplied by (-1).

B. Based on the information supplied in the problem select the correct amount for the year 1967 for each of the items listed below (computed on net income of $100,000 for 1967 before deducting the president's bonus or the state and federal income taxes):

6. The total bonus due the president for 1967 is
   a. $12,037.13.
   b. $11,242.60
   c. $10,090.29.
   d. $9,532.41.

7. The state income tax for 1967 is
   a. $4,525.00.
   b. $4,522.13.
   c. $4,437.87.
   d. $3,994.08.

8. The federal income tax for 1967 is
   a. $47,500.00.
   b. $42,750.00.
   c. $42,159.76.
   d. $37,943.79.

9. The total tax saving from the president's bonus (to be added to his basic bonus of 10 per cent of net income after taxes before deduction of the bonus) is
   a. $5,902.37.
   b. $5,340.24.
   c. $5,287.36.
   d. $5,250.00.

10. Net income for 1967 after deducting the president's bonus and the state and federal income taxes is
   a. $42,750.00.
   b. $42,367.23.
   c. $42,159.77.
   d. $37,943.79.

C. Without regard to the above requirements, assume that in addition to the information given in the problem Williams Company also realized a $20,000 long-term capital gain in 1967. The gain is subject to a 25 per cent federal income tax but not subject to state income tax. The president is not to receive a bonus on the gain nor is his bonus to be charged with the related tax on the gain. Using the letters listed below, select the correct formulation of the algebraic equations to compute the items indicated for 1967:

Let: B = total bonus to the president
S = state income tax
F = federal income tax on ordinary income
F_t = total federal income tax
T = total tax saving on bonus
I = ordinary income before deducting bonus and income taxes
G = long-term capital gain
w = bonus rate
x = state income tax rate
y = federal income tax rate on ordinary income
z = federal income tax rate on long-term capital gain

11. The total bonus to the president could be expressed
   a. $B = w[I + (S + F)] - T$
   b. $B = wI - w(S + F) + T$
   c. $B = T - w(F - S) - wI$
   d. $B = w[(I + B) - T] + [(F_t - F) + S]$

12. The state income tax could be expressed
   a. $S = x(I - B)$
   b. $S = x(I - T)$
   c. $S = x(I - T) + xB$
   d. $S = x(I + G) - T$

13. The federal income tax on ordinary net income could be expressed
   a. $F = y(I - S) - B$
   b. $F = y[I - (B + S)]$
   c. $F = y(I + T) - S$
   d. $F = xB - y(I - S)$
14. The total federal income tax could be expressed
   a. $F_t = yI + zG$
   b. $F_t = z(I + G) - F$
   c. $F_t = yF + zG$
   d. $F_t = zG + F$
15. The total federal and state income tax saving that will be added to the president's basic bonus could be expressed
   a. $T = y(B + S) + xS$
   b. $T = y(B - T)$
   c. $T = B - (yF + xS)$
   d. $T = [xI + y(I - xI)] - (S + F)$

Number 6

You were engaged to examine the financial statements of the Mayfair School District for the year ended June 30, 1967 and were furnished the General Fund trial balance which appears on page 240.

Your examination disclosed the following information:

1. The recorded estimate of losses for the current year taxes receivable was considered to be sufficient.

2. The local government unit gave the school district twenty acres of land to be used for a new grade school and a community playground. The unrecorded estimated value of the land donated was $50,000. In addition a state grant of $300,000 was received and the full amount was used in payment of contracts pertaining to the construction of the grade school. Purchases of classroom and playground equipment costing $22,000 were paid from general funds.

3. Five years ago a 4%, 10 year, sinking fund bond issue in the amount of $1,000,000 for constructing school buildings was made and is outstanding. Interest on the issue is payable at maturity. Budgetary requirements of an annual contribution of $90,000 and accumulated earnings to date aggregating $15,000 were accounted for in separate Sinking Fund accounts.

4. Outstanding purchase orders for operating expenses not recorded in the accounts at year end were as follows:

Administration	$1,000
Instruction	1,200
Other	600
Total	$2,800

5. The school district operated a central machine shop. Billings amounting to $950 were properly recorded in the accounts of the General Fund but not in the Working Capital Fund.

Required:

a. Prepare the formal adjusting and closing entries for the General Fund.

b. The foregoing information disclosed by your examination was recorded only in the General Fund. Prepare the formal adjusting journal entries for the (1) General Fixed Asset Group, (2) Bonded Debt and Interest Group, and (3) Working Capital Fund.

Mayfair School District

GENERAL FUND TRIAL BALANCE

June 30, 1967

	Debit	*Credit*
Cash	$ 47,250	
Taxes receivable—current year	31,800	
Estimated losses—current year taxes		$ 1,800
Temporary investments	11,300	
Inventory of supplies	11,450	
Buildings	1,300,000	
Estimated revenues	1,007,000	
Appropriations—operating expenses		850,000
Appropriations—other expenditures		150,000
State grant revenue		300,000
Bonds payable		1,000,000
Vouchers payable		10,200
Due to working capital fund		950
Operating expenses:		
Administration	24,950	
Instruction	601,800	
Other	221,450	
Debt service from current funds (principal and interest)	130,000	
Capital outlays (equipment)	22,000	
Revenues from tax levy, licenses and fines		1,008,200
General fund equity		80,850
Unappropriated budgeted surplus		7,000
Totals	$3,409,000	$3,409,000

EXAMINATION IN AUDITING

May 16, 1968; 8:30 a.m. to 12:00 m.

All questions are required.

Number 1 (Estimated time—25 to 30 minutes)

Instructions

Each of the numbered statements following is either true or false. Write on a separate answer sheet whether each statement is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

An example of the manner in which the question should be marked is shown in the following illustration:

Question

W. A mean is a computed average.
X. It is impossible to estimate the mean of a population from the mean of a sample drawn from that population
Y. Input-output devices are not part of a computer's hardware.
Z. Debugging is the process of locating and correcting errors in a computer program.

Answer Sheet

W. True
X. False
Y. False
Z. True

Questions to be Answered

A. The first ten statements following apply to unrestricted random sampling with replacement, a sampling technique which may be employed by an auditor under proper circumstances.

1. The auditor's prior knowledge of the materiality of the items to be tested may negate the need for random selection.
2. A rigid definition of the population of accounts receivable must specify that only active accounts with balances be included.
3. If a population consists mostly of accounts with large balances, it is acceptable to exclude accounts with small balances from the population to be sampled because the error in a small balance could not be material.

4. Excluding extremely large items from the definition of the population and evaluating them separately so that they have no chance of being included in the sample would violate the definition of unrestricted random sampling.
5. To be random a sample must be completely unbiased and its selection governed completely by chance.
6. If there is great variability in the number of entries on each item to be sampled, the population could be defined first to select a random sample of items (such as invoices) and then to select a random sample of one entry (quantity and/or price and/or amount) from each item selected.
7. The precision of an estimate of a population mean from a sample mean increases as the degree of confidence in the estimate increases.
8. It is likely that five different random samples from the same population would produce five different estimates of the true population mean.
9. A 100 per cent sample would have to be taken to attain a precision range of ± $0 with 100 per cent reliability.
10. The standard deviation can be used to predict the probable range of difference between a sample mean and the population mean.

B. An auditor should be familiar with the terminology employed in electronic data processing even though he may not utilize an electronic computer in conducting an examination. The next ten statements contain some of the terminology so employed.

11. An error listing will not be produced as a byproduct of processing by a computer unless provision was made for such a listing in the program.
12. An internal label is one of the controls built into the hardware by the manufacturer of a magnetic tape system.
13. An index register is a listing of references to the computer programs maintained at the computer installation.
14. The term "grandfather-father-son" refers to a method of computer record security rather than to generations in the evolution of computer hardware.
15. A control total is an example of a self-checking number within a batch control.
16. Most accounting applications would be processed on a digital computer rather than on an analog computer.
17. An assembly printout would be required to audit around the computer.
18. Magnetic tape storage is generally employed with batch sequential processing rather than with random processing of data.
19. A test deck can be contained on magnetic or paper tape as well as on punched cards.
20. Field validity tests are employed to determine whether or not a computer word has the proper parity.

Number 2 (Estimated time—25 to 30 minutes)

You have been engaged by Central Savings and Loan Association to examine its financial statements for the year ended December 31, 1967. The CPA who examined the financial statements at December 31, 1966 rendered an unqualified opinion.

In January 1967 the Association installed an on-line real-time computer system. Each teller in the Association's main office and seven branch offices has an on-line input-output terminal. Customers' mortgage payments and savings account deposits and withdrawals are recorded in the accounts by the computer from data input by the teller at the time of the transaction. The teller keys the proper account by account number and enters the information in the terminal keyboard to record the transaction. The accounting department at the main office has both punched card and typewriter input-output devices. The computer is housed at the main office.

In addition to servicing its own mortgage loans the Association acts as a mortgage servicing agency for three life insurance companies. In this latter activity the Association maintains mortgage records and serves as the collection and escrow agent for the mortgagees (the insurance companies) who pay a fee to the Association for these services.

Required:

a. Assume you determine that an adequate system of internal control is in effect. Prepare an audit program for the examination of the mortgage accounts for which the Association acts as the mortgage servicing agency. (Do not consider computer processing of the mortgage accounts in your audit program).

b. You would expect the Association to have certain internal controls in effect because an on-line real-time computer system is employed. List the internal controls which should be in effect solely because this system is employed, classifying them as:

1. Those controls pertaining to input of information.
2. All other types of computer controls.

Number 3 (Estimated time—25 to 30 minutes)

The inspection of the minutes of meetings is an integral part of a CPA's examination of a corporation's financial statements.

Required:

a. A CPA should determine if there is any disagreement between transactions recorded in the corporate records and actions approved by the corporation's board of directors. Why is this so and how is it accomplished?

b. Discuss the effect each of the following situations would have on specific audit steps in a CPA's examination and on his auditor's opinion:

1. The minute book does not show approval for the sale of an important manufacturing division which was consummated during the year.
2. Some details of a contract negotiated during the year with the labor union are different from the outline of the contract included in the minutes of the board of directors.
3. The minutes of a meeting of directors held after the balance sheet date have not yet been written, but the corporation's secretary shows the CPA notes from which the minutes are to be prepared when the secretary has time.

c. What corporate actions should be approved by stockholders and recorded in the minutes of the stockholders' meetings?

Number 4 (Estimated time—25 to 30 minutes)

The Halpern Corporation became your client in 1967 when its former CPA died. You have completed your initial examination of Halpern Corporation's financial statements for the year ended December 31, 1967 and have prepared a draft of your auditor's report containing your unqualified opinion which was addressed to the board of directors according to instructions. In addition you have drafted a special report in letter form outlining deficiencies in the system of internal control noted in the course of your examination and your recommendations for the correction of these deficiences.

When you reviewed the drafts of these reports with Halpern's president, he instructed you not to render the internal control letter. The president stated that he was aware the deficiencies existed and would give them his personal attention. Because he felt the board of directors should be concerned with major policy decisions and not with day-to-day management problems the president believed the board should not be burdened with such matters.

Required:

a. 1. What factors would you consider before deciding whether or not you should render the internal control letter?

2. If you decide to render the internal control letter to Halpern Corporation, should it be rendered to the board of directors or the president? **Discuss.**

b. Early in your examination you noted that the factory foreman approved time cards for hours worked and hourly rates and that he also distributed the factory payroll checks.

1. Describe the alternative controls you would look for before concluding that an internal control weakness does in fact exist.
2. If you find no alternative controls are in effect for the factory payroll, what steps in your factory payroll audit program would serve as a test for possible errors or irregularities? List only the procedures which would be of benefit in testing for this specific weakness.

Number 5 (Estimated time—25 to 30 minutes)

You have been assigned by your firm to complete the examination of the 1967 financial statements of Carter Manufacturing Corporation because the senior accountant and his inexperienced assistant who began the engagement were hospitalized because of an accident. The engagement is about one-half completed. Your auditor's report must be delivered in three weeks as agreed when your firm accepted the engagement. You estimate that by utilizing the client's staff to the greatest possible extent you can complete the engagement in five weeks. Your firm cannot assign an assistant to you.

The working papers show the status of work on the examination as follows:

1. *Completed*—Cash, fixed assets, depreciation, mortgage payable and stockholders' equity.

2. *Completed except as noted later*—Inventories, accounts payable, tests of purchase transactions, and payrolls.
3. *Nothing done*—Trade accounts receivable, inventory receiving cutoff and price testing, accrued expenses payable, unrecorded liability test, tests of sales transactions, payroll deductions test and observation of payroll check distribution, other expenses, analytic review of operations, vouching of December purchase transactions, auditor's report, internal control investigation, internal control letter, minutes, preparation of tax returns, procedural recommendations for management, subsequent events, supervision and review.

Your review discloses that the assistant's working papers are incomplete and were not reviewed by the senior accountant. For example, the inventory working papers present incomplete notations, incomplete explanations and no cross-referencing.

Required:

a. What field work standards have been violated by the senior accountant who preceded you on this assignment? Explain why you feel the work standards you list have been violated.

b. In planning your work to complete this engagement you should scan work papers and schedule certain work as soon as possible and also identify work which may be postponed until after the report is rendered to the client.

1. List the areas on which you should plan to work first, say in your first week of work, and for each item explain why it deserves early attention.
2. State which work you believe could be postponed until after the report is rendered to the client and give reasons why the work may be postponed.

Number 6 (Estimated time—25 to 30 minutes)

About two years ago you were engaged to conduct an annual audit of Pierson Company. This was shortly after the majority stockholders assumed control of the Company and discharged the president and several other corporate officers. A new president cancelled a wholesaler's contract to distribute Pierson Company products. The wholesaler is a Pierson Company minority stockholder and was one of the discharged officers. Shortly after you commenced your initial audit, several lawsuits were filed against Pierson Company by the wholesaler. Pierson Company filed countersuits.

None of the suits have been decided. The principal litigation is over the cancelled contract and the other suits are claims against the Company for salary, bonus, and pension fund contributions. Pierson Company is the plaintiff in suits totaling approximately $300,000 and defendant in suits totaling approximately $2,000,000. Both amounts are material in relation to net income and total assets. Pierson's legal counsel believes the outcome of the suits is uncertain and that all of the suits are likely to be "tied-up in court" for an extended time.

You were instructed by the board of directors each year to issue an audit report only if it contained an unqualified opinion. Pierson Company refuses to provide for an unfavorable settlement in the financial statements because legal counsel advised the board of directors that such a provision in the financial statements could be used against Pierson by the opposition in court. The pending litigation was fully disclosed in a footnote to the financial statements, however.

You did not issue a report on the completion of your audit one year ago and you have now completed your second annual audit. The scope of your audits was not restricted in any way and you would render unqualified opinions if there were no pending litigations. You have attended all meetings of the stockholders and the directors and answered all questions directed to you at these meetings. You were promptly paid for all work completed to the current date. The board of directors of Pierson Company invited you to deliver to them an audit report containing an unqualified opinion or to attend the annual meeting of the stockholders one week hence to answer questions concerning the results of your audit if you are unwilling to render an unqualified opinion.

Required:

a. Discuss the issues raised for the CPA by the fact that he attended the stockholders' and directors' meetings and answered all questions addressed to him. Do not consider the propriety of his failure to issue a written audit report.

b. Should a CPA issue his audit report promptly after he has completed his examination? Why?

c. 1. What kind of auditor's opinion would you render on Pierson Company's financial statements for the year just ended? Why? (You need not write an auditor's opinion.)

2. Informative disclosures are usually contained in the middle paragraph of the short form auditor's report. Write the middle paragraph that you would include in your short form auditor's report for Pierson Company's financial statements for the year just ended.

Number 7 (Estimated time—25 to 30 minutes)

Sorenson Manufacturing Corporation was incorporated on January 3, 1966. The corporation's financial statements for its first year's operations were not examined by a CPA. You have been engaged to examine the financial statements for the year ended December 31, 1967 and your examination is substantially completed. The corporation's trial balance appears on page 247.

The following information relates to accounts which may yet require adjustment:

1. Patents for Sorenson's manufacturing process were acquired January 2, 1967 at a cost of $68,000. An additional $17,000 was spent in December 1967 to improve machinery covered by the patents and charged to the Patents account. Depreciation on fixed assets has been properly recorded for 1967 in accordance with Sorenson's practice which provides a full year's depreciation for property on hand June 30 and no depreciation otherwise. Sorenson uses the straight-line method for all depreciation and amortization.

Sorenson Manufacturing Corporation

TRIAL BALANCE

At December 31, 1967

	Trial Balance Debit	Trial Balance Credit
Cash	$ 11,000	
Accounts receivable	42,500	
Allowance for doubtful accounts		$ 500
Inventories	38,500	
Machinery	75,000	
Equipment	29,000	
Accumulated depreciation		10,000
Patents	85,000	
Leasehold improvements	26,000	
Prepaid expenses	10,500	
Organization expenses	29,000	
Goodwill	24,000	
Licensing agreement No. 1	50,000	
Licensing agreement No 2.	49,000	
Accounts payable		147,500
Deferred credits		12,500
Capital stock		300,000
Retained earnings, January 1, 1967	27,000	
Sales		668,500
Cost of goods sold	454,000	
Selling and general expenses	173,000	
Interest expense	3,500	
Extraordinary losses	12,000	
Totals	$1,139,000	$1,139,000

2. On January 3, 1966 Sorenson purchased two licensing agreements which were then believed to have unlimited useful lives. The balance in the Licensing Agreement No. 1 account includes its purchase price of $48,000 and expenses of $2,000 related to the acquisition. The balance in the Licensing Agreement No. 2 account includes its $48,000 purchase price and $2,000 in acquisition expenses but it has been reduced by a credit of $1,000 for the advance collection of 1968 revenue from the agreement.

In December 1966 an explosion caused a permanent 60 per cent reduction in the expected revenue-producing value of licensing agreement No. 1 and in January 1968 a flood caused additional damage which rendered the agreement worthless.

A study of licensing agreement No. 2 made by Sorenson in January 1967 revealed that its estimated remaining life expectancy was only 10 years as of January 1, 1967.

3. The balance in the Goodwill account includes (a) $8,000 paid December 30, 1966 for an advertising program which it is estimated will assist in increasing

Sorenson's sales over a period of 4 years following the disbursement and (b) legal expenses of $16,000 incurred for Sorenson's incorporation on January 3, 1966.

4. The Leasehold Improvements account includes (a) the $15,000 cost of improvements with a total estimated useful life of 12 years which Sorenson, as tenant, made to leased premises in January 1966, (b) movable assembly line equipment costing $8,500 which was installed in the leased premises in December 1967 and (c) real estate taxes of $2,500 paid by Sorenson in 1967 which under the terms of the lease should have been paid by the landlord. Sorenson paid its rent in full during 1967. A 10 year nonrenewable lease was signed January 3, 1966 for the leased building which Sorenson used in manufacturing operations.

5. The balance in the Organization Expenses account properly includes costs incurred during the organizational period. The Corporation has exercised its option to amortize organization costs over a 60-month period for federal income tax purposes and wishes to amortize these costs for accounting purposes.

Required:

Prepare a worksheet to adjust accounts which require adjustment and prepare financial statements.

A separate account should be used for the accumulation of each type of amortization and for each prior period adjustment. Formal adjusting journal entries and financial statements are *not* required.

EXAMINATION IN COMMERCIAL LAW

May 17, 1968; 8:30 a.m. to 12:00 m.

All questions are required.

Number 1 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the Uniform Partnership Act. Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

An example of the manner in which the question should be marked is shown in the following illustration:

Question

XX. The following elements are necessary to constitute a pledge:
1. Possession by the pledger.
2. Property used to secure a loan or other obligation.
3. Either real or personal property.
4. A right of redemption retained by the pledger.
5. Title retained by the pledger.

Answer Sheet

1. False
2. True
3. False
4. True
5. True

Questions To Be Answered

A. Edward and Arnold, two brothers, inherited their deceased father's factory under the provisions of his will. The will provided that the brothers were to own the factory jointly and run it as partners. Edward and Arnold decided, however, that they did not wish to be partners. Instead, it was agreed between them that Edward, the older brother, would employ Arnold and pay him a portion of the profits from the business as a salary. Later Edward and Arnold decided that a partnership would be better and they orally agreed to be partners. A lawyer later drew a formal partnership agreement for the brothers. After executing the partnership agreement and leaving the lawyer's office Edward and Arnold orally agreed to change the terms of the agreement.

1. Edward and Arnold became partners when their father's will took effect at his death.
2. Edward and Arnold became obligated at the time their father executed his will to become partners upon his death.
3. The arrangement for Edward to employ Arnold did not constitute a partnership.
4. A partnership was created prior to the execution of the written partnership agreement by the oral agreement between Edward and Arnold.
5. The written partnership agreement could not be orally modified.

B. Five individuals gathered one evening to discuss the formation of an investment club to provide for joint stock investments. The suggestion was made that the investment club be formed as a partnership and this suggestion was unanimously adopted. Then other ideas were discussed.

It would be possible to have a partnership even if it was also decided that

6. The investment club is to be a nonprofit organization donating all of its income to charity.
7. The investment club is to be a profit-making organization and the gains on the sale of stocks are to be divided unequally among only three members with all dividends received going to the other two members.
8. Only four of the individuals will make capital contributions.
9. The investment club is not to employ any personnel on a salary basis.
10. The investment club is not to be held out as a partnership to the public.

C. The partners in a partnership composed of seven members have differing views on several partnership issues. If the partnership agreement makes no provision for the number of partners required to decide particular issues, the necessary authority would exist

11. To require the discharge of a clerk accused of stealing if only two partners are in favor.

12. To cause the dissolution of the partnership if only three partners are in favor.
13. To require the change of the partnership business from a wholesale to a retail operation if only four partners are in favor.
14. To require the submission of a partnership claim to arbitration if only five partners are in favor.
15. To submit to a confession of judgment on behalf of the partnership if only six partners are in favor.

D. Alvin, Barry and Charles are in business together as partners. Alvin is the active manager of the business. Barry and Charles are wealthy and do not work in the business. Although the partnership is a financial success, Alvin has personal losses and an involuntary bankruptcy petition was filed against him by his individual creditors. Daniel offered to purchase Alvin's interest and to enter the partnership either as a working partner or as a nonworking partner.

16. Alvin's individual creditors may not force the partnership into bankruptcy to gain access to Alvin's interest in the partnership.
17. After being adjudicated a bankrupt, Alvin retains full power to deal with third persons and to bind the partnership so long as he acts in good faith.
18. After Alvin is adjudicated a bankrupt, Barry and Charles may not continue to operate as a partnership without a dissolution even if a satisfactory agreement is reached to pay the value of Alvin's interest to the trustee in bankruptcy.
19. Daniel may not enter the partnership as a nonworking partner because the partnership must have at least one member working in the business in a managerial capacity.
20. If Daniel purchases Alvin's interest and enters the partnership as an active partner, Daniel will not be personally liable for partnership debts incurred while Alvin was a member of the partnership.

E. Frank, Gerald and James are partners in an insurance brokerage firm. Their partnership agreement states that "profits earned by them are to be shared equally." Frank's father is a well-known insurance broker and Frank, without his father's knowledge, often represents to clients that his father is associated with the firm. Gerald, to make extra money, sells real estate on weekends over the objection of his fellow partners who feel that this part-time activity damages the image of the partnership. They informed Gerald that if he continues to sell real estate his profits from real estate sales must be turned over to the partnership. James was named as an executor in a will and is now administering the estate.

21. Frank's father may be found to be a partner by estoppel.
22. Gerald is violating his duty to the partnership by selling real estate.
23. If Gerald continues to sell real estate he need not share his profits from real estate sales with his partners.
24. James must share any income earned as executor with his partners.
25. Each partner is free to render insurance brokerage services to non-partnership clients after normal working hours and need not inform his partners of this or bring these clients to the partnership so long as he does not handle these matters during the normal working day or use partnership supplies.

F. Jane, Carol, Edith and Alice formed a partnership. Capital contributions were: Jane, $13,000; Carol, $10,000; Edith, $5,000; and Alice made no capital contribution. There was no provision for sharing profits or losses in the partnership agreement. The partnership owes Jane $6,000 for a loan which has not been repaid. The assets of the partnership are worth $20,000 and the partnership owes $26,000 to trade creditors. The partners decide to terminate the partnership and Edith agrees to take charge of the liquidation. Upon liquidation

26. Each partner must contribute an additional $1,500.
27. Jane may demand interest on the loan she made to the partnership in the absence of any provision in the partnership agreement.
28. Carol will not be required by the partners to make an additional contribution to the partnership to cover losses.
29. The partners can agree that Edith will receive additional compensation for her work in liquidating the partnership.
30. Unpaid creditors may not sue the individual partners while the partnership continues to remain in existence.

Number 2 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the **provisions of Article 3 (Commercial Paper) of the Uniform Commercial Code.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. An instrument reads as follows:

No. 452

Pay
to the
Order of Richard Smith

April 1, 1968

$100.00

One Hundred and no/100 Dollars

Fireman's Bank
Chicago, Illinois

Roberta Jones

31. This instrument is a bill of exchange.
32. Roberta Jones is the drawee.
33. Fireman's Bank is the drawer.
34. Richard Smith is the payee.
35. This instrument is a draft.

B. An instrument reads as follows:

$250.00 Chicago, Illinois April 1, 1968

Thirty days after date I promise to pay to the
order of Cash
Two hundred and fifty Dollars
at New York City

Value received with interest at the rate of six per cent per annum. This instrument arises out of a separate agreement.

No. 20 Due May 1, 1968 Robert Smith

36. This instrument is a draft.
37. This instrument is order paper.
38. This is not a negotiable instrument.
39. Robert Smith is the maker.
40. This instrument may be negotiated without an indorsement.

C. Andrews owed Martin, his accountant, a fee for services rendered. Andrews drew a check on his bank payable to "Cash" and signed it. He left the amount blank because he was not sure of the exact amount owed. On his way to Martin's office Andrews lost the check. Oliver found the check, filled it in for $500 and handed it to Ernest to satisfy a $500 debt which Oliver owed to Ernest. Ernest accepted the check in good faith as payment for the debt. Meanwhile, Andrews stopped payment on the check.

41. If Andrews' bank is told the circumstances under which Ernest accepted the check when he presents it for payment, the bank would be acting improperly if it obeyed the stop payment order.
42. Martin must now look to Oliver rather than Andrews for payment of the fee due from Andrews.
43. If Ernest sues Andrews on the instrument, Andrews will have a real defense.
44. If Ernest sues Andrews on the instrument, Ernest may be able to prove he is a holder in due course.
45. If Andrews orally requested his bank to stop payment on the check the request would not be binding on the bank.

D. Roberts was a holder in due course of a properly drawn check payable to "Bearer." He indorsed the check as follows:

"Pay to the order of Wilson Hall without recourse.
Peter Roberts"

Roberts then transferred the instrument to Hall who in turn negotiated it to Miles, who is now a holder in due course.

46. Roberts' indorsement is both a qualified indorsement and a special indorsement.
47. Hall must have been a holder in due course.
48. By his indorsement Roberts made warranties to Miles.
49. By his indorsement Roberts made warranties to Hall but these warranties are not the same as the warranties which would be made by an indorser who indorses an instrument in blank.
50. Roberts' indorsement of the instrument and his transfer of it to Hall represents a negotiation.

E. Justin was a holder in due course of a properly drawn check payable to "Bearer." He indorsed the check as follows:

"Pay to Edward Evans or order.
John Justin"

Justin then transferred the check to Evans. Evans in turn negotiated the check to Diamond who proceeded to have the bank on which the check was drawn certify the check.

51. Until the bank certified the check the drawer of the check was primarily liable for its payment.
52. Diamond is a holder of the check.
53. Evans did not have to indorse the check in order to negotiate it to Diamond.
54. The bank on which the check was drawn was not obligated to certify the check unless it had specifically agreed to do so.
55. When the bank on which the check was drawn certified the check at Diamond's request both the drawer and all the indorsers were discharged.

F. Casey held a negotiable instrument payable to his order. He transferred the instrument to Dale for value. At the time of transfer Casey failed to indorse his name on the back of the instrument and Dale accepted the instrument as given to him.

56. If Dale realized that Casey did not indorse the instrument when he accepted it, Dale waived his right to receive Casey's indorsement.
57. Casey may not deny Dale the right to his indorsement but Casey has the right to qualify the indorsement.
58. If Casey is a holder in due course of the instrument Dale will be entitled to assert Casey's rights from the time the instrument was transferred to him if Dale has acted in good faith and without notice of any defects.
59. The instrument cannot be negotiated to Dale without Casey's indorsement.
60. Even if Dale receives Casey's indorsement Dale cannot be a holder in due course of the instrument.

Number 3 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion, drawn from the facts given in the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the **general principles of insurance law.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions To Be Answered

A. Arthur owed Super Auto Sales Incorporated $2,000 as the balance due on the purchase of a new automobile from Super Auto Sales. Super obtained a perfected security interest in the auto pursuant to the provisions contained in Article 9 (Secured Transations) of the Uniform Commercial Code. In addition Arthur owed $5,000 to the Goodwill Credit Union for a personal loan. Goodwill was an unsecured creditor.

Super Auto Sales and the Goodwill Credit Union each took out $2,000 of property insurance (fire, theft, collision, etc.) on the auto at the time it was purchased because this was one of the few assets Arthur owned. Goodwill also insured Arthur's life for $5,000 at the time they loaned him the money.

Arthur subsequently satisfied both loans fully. However, each party continued to pay the premiums on the original policies.

Later Arthur had an accident which resulted in his death and the total destruction of the automobile. The insurance policies were still in force.

61. Super Auto Sales initially had a valid insurable interest in the automobile purchased by Arthur.
62. The Goodwill Credit Union did not have an insurable interest in the automobile at any time.
63. Super Auto Sales is entitled to recover $2,000 from the auto insurance policy.
65. The Goodwill Credit Union is entitled to recover $5,000 from the life insurance policy.
65. If the accident which caused Arthur's death and the destruction of the automobile was Arthur's fault, the respective insurance companies would be able to avoid liability on this basis.

B. Wallace owned all the shares of stock of Marker Corporation. Marker Corporation owned a large factory building in which its product was manufactured. The building was worth $250,000.

Wallace insured the building for $250,000 against loss from fire. He inadvertently took out the policy in his own name, indicating that he rather than the corporation was the owner of the building. Fire subsequently totally destroyed the building.

66. The Statute of Frauds requires that the insurance contract be in writing.
67. Wallace, in his official capacity, could legally execute a quitclaim deed to the building and deliver the deed to a prospective purchaser.
68. Wallace will be unable to recover the $250,000 loss covered by the fire insurance policy.
69. If it is assumed that Wallace had no insurable interest in the building, he may nevertheless recover the premiums paid.
70. If Wallace had sold all his shares in the Marker Corporation prior to the destruction of the building, he could not recover on the first insurance policy.

C. Horace obtained a $50,000 life insurance policy on his own life. He named his wife and a partner in his CPA firm as co-beneficiaries. He also had a $25,000 fire insurance policy on his home. These policies contain the standard provisions common to the type of insurance policy involved.

Both policies are three years old and are held for Horace's convenience by the insurance agent-broker who sold him the policies.

71. Since there has been no delivery of the policies to Horace, they are not valid contracts.
72. Horace's wife and his partner, as co-beneficiaries, own the life insurance policy.
73. The life insurance policy is freely assignable without the consent of the insurance company.

74. If Horace sells his home, he can assign the insurance policy to the purchaser even though the insurance company does not consent to the transfer of the policy.
75. Because he lacks the requisite insurable interest in Horace's life, Horace's partner will be unable to collect on the policy.

D. Franklin was the owner of a building valued at $80,000. Because he did not believe that a fire would result in a total loss, he procured a $40,000 standard fire insurance policy on the property from the Ace Fire Insurance Company. The policy contained an 80 per cent coinsurance clause.

Four years later, while the policy was still in effect and the value of the building was $100,000, a fire occurred which resulted in a $40,000 loss.

76. The coinsurance clause requires Franklin to insure the building for 80 per cent of its value or he will receive nothing in the event of partial destruction.
77. If the insurance company wished, it could have required a 100 per cent coinsurance clause in the policy.
78. Franklin is obligated to the insurance company to spend the proceeds obtained from the insurance policy for repair of the building.
79. Franklin will recover $20,000 from the insurance company.
80. In the event of a total destruction of the property insured, the coinsurance clause would have no effect on the amount to be recovered.

E. The Mecca Insurance Company sold a life insurance policy which contained the following clauses:

"This policy shall be incontestable during the lifetime of the insured after it has been in force for a period of two years from its date of issue except for nonpayment of premiums and except for violation of the policy relating to military or naval service in time of war.

"Death as a result of flight, travel or service in any species of aircraft, except as a fare-paying passenger, is a risk not assumed under this policy."

81. Even if the insured dies in an airplane accident in which he was not a fare-paying passenger, the beneficiary will recover if the accident occurs two years or more after issuance of the policy.
82. The incontestable clause will not preclude the Mecca Insurance Company from successfully asserting lack of an insurable interest on the purchaser's part even though the policy had been issued more than five years prior to the insured's death.
83. Proof that the insured had initially misstated his age would be grounds for completely voiding the policy at the time of his death three years later.
84. Many states require that an incontestable clause, such as the one printed above or one similar to it, be included in the policy.

85. The incontestable clause will permit the insured's beneficiary to recover, despite the fact that the insured concealed certain material facts, if the insured lives for the requisite two years from issuance of the policy.

F. The Superior Insurance Company sold Goodfellow a life insurance policy which contained the following clause:

"This policy shall constitute the entire contract between the parties, or if a copy of the application is indorsed upon or attached to the policy when issued, the policy and the application therefor shall constitute the entire contract between the parties."

This clause was required by state law to be included in the policy.

86. The above clause indicates that the insurance policy and the application, if it is indorsed thereon, constitute an integration.
87. The above clause would preclude the insurance company from showing that the insured fraudulently concealed material facts.
88. The above clause would preclude the insurance company from proving an oral contemporaneous understanding which varies the terms of the policy.
89. If Goodfellow agreed to it, the clause could be waived by indorsement at the time he obtained the policy.
90. The insurance company will ordinarily indorse upon or attach a copy of the insured's application to the policy.

Number 4 (Estimated time—25 to 30 minutes)

Part a. Frugal, for whom you perform accounting services, told you that he plans to create his own *inter vivos* trust (living trust) and that he plans to name you the trustee.

Frugal showed you the following provision in a draft of the disposition he plans for the trust principal at his death.

"On my death the then principal of the trust shall be distributed to my then living descendants, in equal shares *per stirpes*."

Required:

1. Would such a trust instrument have to be probated as a will at Frugal's death since the trust instrument provides for disposition of the property at death? **Explain.**

2. If you do not wish to serve as trustee is there any way of your avoiding the responsibility even if Frugal insists that he will name you as trustee over your objection? **Explain.**

3. State the percentage of trust principal which each party would receive at Frugal's death if during his life Frugal had only two children, Rita and Selma, and was survived by

(i) John, his brother,
(ii) Susan, his sister,
(iii) Rita, his daughter,
(iv) Thomas and Mary, his grandchildren whose mother is Rita, and
(v) Albert, his grandchild (whose mother, Selma, predeceased Frugal).

Part b. Wellington purchased several thousand dollars worth of corporate securities in the joint names of "Wellington and Potter or the survivor."

Later, Wellington decided that Potter should not receive the corporate securities at Wellington's death because Potter had become wealthy. Wellington, therefore, went to his attorney and executed a codicil to his Last Will and Testament naming his brother as the party to receive the securities upon his death.

Wellington is now dead.

Required:

Who is entitled to the securities in question? **Explain.**

Number 5 (Estimated time—20 to 25 minutes)

During the course of an audit of Acme Produce Company you learn the following:

Acme warehoused 1,000 pounds of beans with Baker Warehouse and Trading Company and received Baker's nonnegotiable warehouse receipt. In addition to being a licensed public warehouse, Baker also regularly bought and sold beans. When Acme delivered its beans to the warehouse, Baker commingled the beans with beans being warehoused for other owners. Then, running short of its own beans, Baker removed 1,000 pounds of beans from its public warehouse and sold them in the normal course of its business as part of its regular stock to Cory Company. Shortly thereafter Baker became insolvent. Acme was the last firm to warehouse beans with Baker prior to Baker's becoming insolvent.

Required:

a. Describe the legal relationship between Acme and Baker in connection with the warehousing of the beans.

b. Define the terms "fungible goods" and "warehouse receipt."

c. Did Baker have a right to commingle the beans delivered by Acme with beans warehoused for other customers? **Explain.**

d. May Acme successfully sue Cory to recover the beans bought from Baker? **Explain.**

e. How will the beans remaining in Baker's warehouse be distributed among owners who delivered beans for warehousing?

f. Would your answers to question "c," "d" or "e" vary if Acme had received a negotiable warehouse receipt from Baker? **Explain.**

Number 6 (Estimated time—20 to 25 minutes)

Part a. Excelsior Bank hired Ronda as a secretary and obtained a surety bond from King covering the Bank against losses up to $50,000 resulting from Ronda's improper conduct in the performance of her secretarial duties.

Both Ronda and the Bank signed the application for the bond. After one year of service Ronda was promoted to the position of teller in the Bank and the original surety bond remained in effect. Shortly after Ronda's promotion a surprise audit revealed that Ronda had taken advantage of her new position and stolen $25,000 from the Bank. She was arrested and charged with embezzlement.

Ronda had assets of only $10,000 at the time of her arrest.

Required:

1. Identify and describe the legal relationship among Excelsior Bank, Ronda and King. Discuss in full the nature of the rights and duties of each of the parties.

2. If the Bank demands a payment of $25,000 from King, what defense, if any, might King raise to deny an obligation to the Bank?

3. If King fully reimburses the Bank for its loss, under what theory or theories, if any, may King attempt to recover from Ronda.

Part b. Martinson made a contract on July 1, 1967 with Penn Oil, Coal and Coke Company for the purchase of 16,000 tons of coal at $9 per ton. The contract was in writing and signed by both parties. Under its terms delivery was to be made as follows: "4,000 tons on October 1, 1967 and 4,000 tons in each of the succeeding months."

Penn decided to terminate its coal and coke operations. Pursuant to this decision, it sold its coal and coke facilities and all related assets on September 1, 1967 to one of its competitors, Banner Coal Company. The assets sold included "all rights under existing contracts for the purchase of coal or coke by our customers."

Penn notified all its former customers of the sale of its coal and coke operations, indicating that henceforth deliveries and service would be supplied by Banner. Banner delivered the agreed-upon 4,000 tons to Martinson on October 1, 1967 and Martinson accepted and paid Banner for the coal without objection. Banner then decided it was unprofitable to make further deliveries to Martinson at the contract price. Banner, therefore, notified Martinson that unless he agreed to pay $10 per ton on future deliveries, Banner would cancel the contract.

Martinson refused to pay the $10 and Banner failed to make the remaining deliveries.

Required:

1. Discuss the legal implications and the relationship between Penn and Banner that arose as a result of the September 1, 1967 transfer of the Martinson contract.
2. Is Banner liable to Martinson for failure to deliver the coal? **Explain.**
3. Can Martinson sue Penn? **Explain.**
4. Assuming that Penn performed after learning of Banner's action, will it have any rights against Banner?

Number 7 (Estimated time—25 to 30 minutes)

Part a. The accounting firm of Smyth, Smyth & Smith of Los Angeles, California hired Watson as a junior. Watson was required, as a condition of employment, to agree in writing that if he left the employ of the firm he would neither establish his own firm nor work for another accounting firm on the West Coast of the United States, including Alaska, for a period of ten years from the date of termination of employment.

Watson worked for several years for Smyth, Smyth & Smith. Subsequently, he left the firm's employ to return to his hometown of Eugene, Oregon where he established his own accounting firm.

Smyth, Smyth, & Smith seek to specifically enforce the prohibitory provision contained in Watson's written employment contract.

Required:

Will Smyth, Smyth & Smith be able to preclude Watson from engaging in the practice of accounting? **Explain.**

Part b. The Jason Corporation sold various interrelated products which it manufactured. One of the items was manufactured almost exclusively by Jason Corporation. It was sold throughout most of the United States. The Corporation realized the importance of the product to its purchasers and decided to capitalize on the situation by requiring all purchasers to take at least two other Jason products in order to obtain the item over which it had almost complete market control.

At the spring sales meeting the president of Jason Corporation informed the entire sales force that they were to henceforth sell only to those customers who agreed to take the additional products. He indicated that this was a great opportunity to substantially increase sales of laggard items.

The plan was adopted and gross sales of the additional items more than doubled and were in excess of one million dollars.

You are the auditor examining the financial statements of Jason Corporation and upon inquiry as to the reason for the great spurt in sales of certain items the above facts came to light.

Required:

1. Discuss the legal problems created by the above set of facts.
2. What are the probable legal actions by customers, competitors and the United States government which Jason Corporation may face as a result of the above facts? **Explain.**

Number 8 (Estimated time—20 to 25 minutes)

Part a. You were requested by Charles to prepare a net worth statement for him as of December 31, 1967 which will be furnished to his bank. You must determine whether or not a truck having a fair market value of $20,000 should be included in Charles's net worth. Charles was in the trucking business as a sole proprietor during 1967. Filmore, Charles's uncle, looked upon Charles as his favorite nephew and wished to help Charles in business. Filmore decided to present Charles with a new truck which Charles needed but lacked the funds to purchase.

Filmore invited Charles to lunch and told him about the intent to make a gift of the truck to him. In fact, he told Charles he had hoped to give him the truck right after lunch, but delivery was not to be made to Filmore until the following week. To evidence his intent Filmore wrote the following on a piece of paper:

> "I hereby acknowledge my intent to make a gift of a new truck to my favorite nephew, Charles. Therefore, for good and valuable consideration, consisting of my love and respect for him, I irrevocably promise to deliver said truck to Charles as soon as I receive it.
>
> Daniel Filmore."

Filmore had two waiters sign the paper as witnesses and gave it to Charles.

Filmore later learned that sometime before the luncheon Charles had been complaining to other relatives that "Uncle Filmore is a tightwad and a cheapskate." Consequently, Filmore refused to turn the new truck over to Charles.

Charles asserts that a valid *inter vivos* gift was made at the luncheon or, in the alternative, that his uncle was equally bound by the promise he made.

Required:

1. What are the requirements necessary to establish a valid *inter vivos* gift?
2. Did Filmore make a gift to Charles at the luncheon? **Explain.**

3. Did Filmore make a legally binding contract with Charles for delivery of the truck? **Explain.**

4. Assuming that the truck had actually been delivered to Filmore prior to the luncheon, that he turned the keys over to Charles at the luncheon and that Charles drove the truck back to his own place of business after the luncheon, would Charles be entitled to the truck? **Explain.**

Part b. Pierre, owner of Ritz Restaurant, Inc., had in his possession several valuable items which wealthy patrons had lost or left in the restaurant. The total value of these items was in excess of $5,000.

Ritz Restaurant's financial position was poor. Consequently, Pierre decided to pledge the items in question as collateral for a loan. He took the items to Friendly Finance Company and obtained a loan of $3,500 on the property pledged.

Required:

1. What is the legal relationship and duty of Pierre of Ritz Restaurant, Inc. to the original owners of the property in question? **Explain.**

2. As between the original owners of the property and Friendly Finance Company, who is entitled to the property? **Explain.**

EXAMINATION IN THEORY OF ACCOUNTS

May 17, 1968; 1:30 p.m. to 5:00 p.m.

All questions are required.

Number 1 (Estimated time—25 to 30 minutes)

Instructions

Select the best answer choice for each of the following items. Write your answer choice on a separate answer sheet. Select only one answer for each item.

An example of the manner in which the questions should be marked is shown in the following illustration:

Question

XX. The current asset section of the balance sheet should include
- a. Machinery.
- b. Cash.
- c. Goodwill.
- d. Taxes payable.

Answer Sheet

XX. b.

Questions To Be Answered

1. Which of the following should not be considered as a current asset in the balance sheet?
   - a. Installment notes receivable due over 18 months in accordance with normal trade practice.
   - b. Prepaid taxes which cover assessments of the following operating cycle of the business.
   - c. Marketable securities purchased by the temporary investment of cash available for current operations.
   - d. The cash surrender value of a life insurance policy carried by a corporation, the beneficiary, on its president.

2. The method of accounting for joint product costs that will produce the same gross profit rate for all products is the
   a. Relative sales value method.
   b. Physical measure method.
   c. Actual costing method.
   d. Split-off costing method.

3. In selecting an accounting method for a newly contracted long-term construction project, the principal factor to be considered should be
   a. The terms of payment in the contract.
   b. The degree to which a reliable estimate of the progress toward contract completion is practicable.
   c. The method commonly used by the contractor to account for his other long-term construction contracts.
   d. The inherent nature of the contractor's technical facilities used in construction.

4. When a corporation's management asks its board of directors to approve a material retroactive payroll adjustment, with which of the following points should the board normally be least concerned?
   a. The computation of the retroactive adjustment.
   b. The need for stockholders' approval.
   c. The basis on which the adjustment is justified.
   d. The status of the adjustment as to deductibility for tax purposes.

5. Which of the following should be recognized as an accountable event in financial statements according to generally accepted accounting principles (assume all amounts are material)?
   a. Receipt of a stock split.
   b. Decline in market value of securities held.
   c. Increase in market value of securities held.
   d. Decrease in selling price of finished goods inventory and a normal profit is expected on the new price.

6. If a corporation purchases a lot and building and subsequently tears down the building and uses the property as a parking lot, the proper accounting treatment of the cost of the building would depend on
   a. The significance of the cost allocated to the building in relation to the combined cost of the lot and building.
   b. The length of time for which the building was held prior to its demolition.
   c. The contemplated future use of the parking lot.
   d. The intention of management for the property when the building was acquired.

7. Cost-volume-profit relationships which are curvilinear may be analyzed linearly by considering only

a. A relevant range of volume.
b. Relevant fixed costs.
c. Relevant variable costs.
d. Fixed and semi-variable costs.

8. In analysis of standard cost variances the item which receives the most diverse treatment in accounting is

a. Direct labor cost.
b. Manufacturing overhead cost.
c. Direct material cost.
d. Fixed costs.

9. The practice of offsetting assets against a tax liability to a governmental body on a balance sheet is

a. Acceptable but may be applied only for current assets.
b. Unacceptable except for government securities.
c. Unacceptable unless a right of offset exists.
d. Acceptable if the tax liability will be paid within the next operating cycle.

10. The installment method of recognizing profit for accounting purposes is acceptable if

a. Collections in the year of sale do not exceed 30% of the total sales price.
b. An unrealized profit account is credited.
c. Collection of the sales price is not reasonably assured.
d. The method is consistently used for all sales of similar merchandise.

11. The liability, deferred and net of tax methods of interperiod allocation of corporate income taxes will produce different net income if there is

a. A timing difference in reporting income.
b. A change in tax rates.
c. An operating loss.
d. An income fluctuation as the result of an extraordinary gain.

12. The occurrence which most likely would have no effect on 1967 net income (assuming that all amounts involved are material) is the

a. Sale in 1967 of an office building contributed by a stockholder in 1950.
b. Collection in 1967 of a receivable from a customer whose account was written off in 1966.
c. Settlement based on litigation in 1967 of previously unrecognized damages from a serious accident which occurred in 1965.
d. Worthlessness determined in 1967 of stock purchased on a speculative basis in 1964.

13. Earnings per share of common stock as reported on the statement of income and retained earnings should be computed on the basis of

a. The number of shares outstanding at the end of the year.
b. A weighted average of the number of shares outstanding during the year regardless of the extent of fluctuations.
c. A weighted average of the number of shares outstanding during the year, except that minor fluctuations in the number of shares may be disregarded.
d. The number of shares outstanding in the middle of the year.

14. A company that spends considerable amounts on its research and development program should

a. Charge them to expense in the period in which they are incurred.
b. Charge them to a deferred expense account (asset), with charges to expense and contra credits to an allowance for deferred research expense account made periodically based on probability of success of individual projects.
c. Charge them to a deferred expense account (asset), with transfer from that account made either to intangible assets or expense at the time a project is completed.
d. Charge them to expense in the period incurred, with reasonable charges to appropriate asset accounts by crediting expense when usable or patentable products or processes are developed.

15. The most common method of recording depletion for accounting purposes is the

a. Percentage depletion method.
b. Decreasing charge method.
c. Straight line time method.
d. Units of production method.

16. The method of project selection which considers the time value of money in a capital budgeting decision is accomplished by computing the

a. Discounted cash flow.
b. Payback period.
c. Rate of return on initial investment.
d. Rate of return on average investment.

17. A significant nonrecurring retroactive settlement in the current year of federal income taxes for a prior year should be treated in the statement of income and retained earnings as

a. An expense deducted from gross profit from operations.
b. An extraordinary item deducted in determining net income.
c. An adjustment to retained earnings of the beginning of the year.
d. An addition to the current year's income tax expense with a footnote to explain the additional amount.

18. When the following option dates are different, compensation from a stock option is measured by comparing the option price with the market value of the stock on the date that the

a. Grantee has fulfilled all conditions of the option.
b. Option is granted to the individual.
c. Option plan is adopted.
d. Option is exercised.

19. The "past service cost" of a pension plan should be
    a. Charged to retained earnings as a cost related to the past.
    b. Amortized over a specified period of years.
    c. Disregarded except that interest thereon is to be provided currently along with the normal cost, unless all benefit payments can not be met on a continuing basis by such annual provisions.
    d. Consistently provided within a defined minimum-maximum range in a manner most realistic in the circumstances.
20. A company in accounting properly for pension cost
    a. Allocates total pension costs systematically and rationally.
    b. Records fluctuating gains and losses on pension fund investments as they occur.
    c. Gives recognition to all pension costs for which legal liability exists.
    d. Establishes a positive relationship between contributions to the fund and the recorded provision.

Number 2 (Estimated time—25 to 30 minutes)

Because of irreconcilable differences of opinion, a dissenting group within the management and board of directors of the Algo Company resigned and formed the Bevo Corporation to purchase a manufacturing division of the Algo Company. After negotiation of the agreement but just before the closing and actual transfer of the property, a minority stockholder of Algo notified Bevo that a prior stockholders' agreement with Algo empowered him to prevent the sale. The minority stockholder's claim was acknowledged by Bevo's board of directors. Bevo's board then organized Casco, Inc. to acquire the minority stockholder's interest in Algo for $75,000, and Bevo advanced the cash to Casco. Bevo exercised control over Casco as a subsidiary corporation with common officers and directors. Casco paid the minority stockholder $75,000 (about twice the market value of the Algo stock) for his interest in Algo. Bevo then purchased the manufacturing division from Algo.

Required:

a. What expenditures are usually includable in the cost of property, plant and equipment acquired in a purchase?

b. 1. What are the criteria for determining whether to consolidate the financial statements of Bevo Corporation and Casco, Inc.?
   2. Should the financial statements of Bevo Corporation and Casco, Inc. be consolidated? **Discuss.**

c. Assume that unconsolidated financial statements are prepared. Discuss the propriety of treating the $75,000 expenditure in the financial statements of the Bevo Corporation as
   1. An account receivable from Casco, Inc.
   2. An investment in Casco, Inc.
   3. Part of the cost of the property, plant and equipment.
   4. A loss.

Number 3 (Estimated time—25 to 30 minutes)

On May 5, 1967 Sterling Corporation signed a contract with Stony Associates under which Stony agreed (1) to construct an office building on land owned by Sterling, (2) to accept responsibility for procuring financing for the project and finding tenants, and (3) to manage the property for 50 years. The annual profit from the project, after debt service, was to be divided equally between Sterling Corporation and Stony Associates. Stony was to accept its share of future profits as full payment for its services in construction, obtaining finances and tenants, and management of the project.

By April 30, 1968, the project was nearly completed and tenants had signed leases to occupy 90 per cent of the available space at annual rentals aggregating $2,600,000. It is estimated that, after operating expenses and debt service, the annual profit will amount to $850,000. The management of Stony Associates believed that the economic benefit derived from the contract with Sterling should be reflected on its financial statements for the fiscal year ended April 30, 1968 and directed that revenue be accrued in an amount equal to the commercial value of the services Stony had rendered during the year, that this amount be carried in contracts receivable, and that all related expenditures be charged against the revenue.

Required:

a. Explain the main difference between the economic concept of business income as reflected by Stony's management and the measurement of income under generally accepted accounting principles.

b. Discuss the factors to be considered in determining when revenue has been realized for the purpose of accounting measurement of periodic income.

c. Is the belief of Stony's management in accord with generally accepted accounting principles for the measurement of revenue and expense for the year ended April 30, 1968? Support your opinion by discussing the application to this case of the factors to be considered for asset measurement and revenue and expense recognition.

Number 4 (Estimated time—25 to 30 minutes)

You have been requested by your client, Acme Restaurants, Inc., a national hotel and motel restaurateur, to evaluate certain accounting treatments proposed by Acme's treasurer regarding a contract for Acme to operate the restaurant and parking facilities of the new Rocklin Hotel for 30 years. A condition necessary for securing the contract was that Acme would aid in financing the new hotel by loaning Rocklin $300,000 in addition to paying a normal rental for the facilities. It is estimated that the operations will yield pre-tax profits of $150,000 annually to Acme.

The $300,000 loan will be for 30 years with no payment unless the contract is cancelled by Rocklin. Interest is to accrue at 4 per cent per year compounded annually for the first 20 years and no interest is to accrue during the last 10 years. After 20 years Acme will cancel 10 per cent of the principal and accrued interest each year. If Rocklin should cancel the contract the uncancelled principal and interest would become payable immediately.

The Company's treasurer has proposed accounting for the transaction over the contract life as a loan receivable with interest income accruing at 4 per cent per year for the first 20 years and the unpaid principal plus accrued interest being charged off at 10 per cent per year over the last 10 years. The treasurer's reasoning is that this accounting treatment will be in accordance with the terms of the legal documents and with the accounting treatment that Rocklin plans to employ. Also, the interest income for each of the first 20 years would enhance earnings during an anticipated growth period and the income tax effect for the first 20 years will be offset in the last 10 years of the contract.

Because the amounts involved will be material from the standpoint of both the income statement and the statement of financial condition, Acme requested your opinion to avoid any statement presentation problems at the end of the year.

Required:

a. Does the treasurer's proposed accounting for the contract constitute proper presentation on the financial statements? Support your conclusions by discussing the effects of the proposed treatment on (1) the income statement and (2) the statement of financial condition. State any alternatives you believe might be preferable.

b. 1. Discuss the treasurer's suggestion to account for the transaction in accordance with the terms of the legal supporting documents.
   2. Discuss the bearing the treatment of the contract by Rocklin Hotel will have in your evaluation of the preferable treatment for Acme.

c. What disclosure, if any, will be necessary in Acme's financial statements in regard to the agreement with Rocklin?

Number 5 (Estimated time—25 to 30 minutes)

The most recently published statement of consolidated income of National Industries, Inc. appears as follows:

National Industries, Inc.
STATEMENT OF CONSOLIDATED INCOME
For the Year Ended March 31, 1968

Net sales	$38,041,200
Other revenue	407,400
Total revenue	38,448,600
Cost of products sold	27,173,300
Selling and administrative expenses	8,687,500
Interest expense	296,900
Total cost and expenses	36,157,700
Income before income taxes	2,290,900
Provision for income taxes	1,005,200
Net income	$ 1,285,700

Charles Norton, a representative of a firm of security analysts, visited the central headquarters of National Industries for the purpose of obtaining more information about the company's operations.

In the annual report National's president stated that National was engaged in the pharmaceutical, food processing, toy manufacturing, and metal-working industries. Mr. Norton complained that the published income statement was of limited utility in his analysis of the firm's operations. He said National should have disclosed separately the profit earned in each of its component industries. Further he maintained that several items appearing on the statement of consolidated retained earnings should have been included on the income statement, namely a gain of $633,400 on the sale of the furniture division in early March of the current year and an assessment for additional income taxes of $164,900 resulting from an examination of the returns covering the years ended March 31, 1965 and 1966.

Required:

a. Explain what is meant by the term "conglomerate" company.

b. 1. Discuss the accounting problems involved in measuring net profit by industry segments within a company.
   2. With reference to National Industries' statement of consolidated income identify the specific items where difficulty might be encountered in measuring profit by each of its industry segments and explain the nature of the difficulty.

c. 1. What criteria should be applied in determining whether a gain or loss should be excluded from the determination of net income?
   2. What criteria should be applied in determining whether a gain or loss that is properly includable in the determination of net income should be included in the results of ordinary operations or shown separately as an extraordinary item after all other items of revenue and expense?
   3. How should the gain on the sale of the furniture division and the assessment of additional taxes each be presented in National's financial statements?

Number 6 (Estimated time—25 to 30 minutes)

Two physics professors at State University incorporated Basic Research Corporation in 1965 to provide research and consulting services to business firms. They engaged you to prepare annual financial statements on an accrual basis. A bookkeeper maintains all records and prepares monthly statements of cash receipts and disbursements. Following are post closing trial balances which reflect all of your adjustments and the cash receipts and disbursements statement which was prepared by the bookkeeper from Corporation records before they were adjusted by you:

Basic Research Corporation

ADJUSTED POST CLOSING TRIAL BALANCES

December 31, 1967 and 1966

	December 31, 1967	*December 31, 1966*
Cash in bank	$ 49,000	$ 10,000
Receivable from clients	47,000	35,000
Completed work not yet billed	24,000	40,000
Technical supplies inventory	7,000	5,000
Land, building and equipment	105,600	50,000
Total debits	$232,600	$140,000
Accumulated depreciation	$ 23,000	$ 12,000
Due to suppliers	4,000	3,000
Prepayments by clients not billed in 1966		28,000
Discounted note and accrued interest payable	35,616	
Deferred salary payable	15,000	
Stock issued ($10 par value)	12,000	10,000
Donated capital	5,000	
Retained earnings	137,984	87,000
Total credits	$232,600	$140,000

Basic Research Corporation

CASH RECEIPTS AND DISBURSEMENTS

For the Year Ended December 31, 1967

Cash received from clients		$260,000
Cash disbursements:		
Administrative salaries	$ 50,000	
Staff salaries	120,000	
Outside consultants	12,000	
Payments to suppliers	9,000	
Laboratory equipment purchased	11,000	
Other laboratory expenses	12,500	
General expenses	6,500	221,000
Cash receipts in excess of cash disbursements		$ 39,000

Additional information available:

1. On January 1, 1967 Basic Research consummated a merger with Engineering Consulting Company which was treated as a pooling of interests with Basic Research surviving. The president (and major stockholder) of the engineering firm was engaged by Basic Research to be the director of applied research until his retirement December 31, 1971 with compensation to be paid in equal amounts over a period of 10 years. The pooling of interests was recorded by the following entry:

Receivable from clients	$8,000	
Laboratory equipment	6,000	
Allowance for depreciation		$5,000
Retained earnings		7,000
Capital stock		2,000

To record the issuance of 200 shares of Basic Research Corporation stock for the assets and retained earnings of Engineering Consulting Company.

2. On January 1, 1967 Basic Research purchased from one of its incorporators some adjacent land on which a new building is to be constructed. The incorporator sold the land to the Corporation for $5,000 less than he was offered by a real estate developer. Because the land was worth more than Basic Research agreed to pay, it was recorded at its fair market value. A note due in 3 years discounted to yield 6 per cent per annum was given in payment ($.84 invested at 6 per cent for 3 years will accumulate to $1).

3. All services to clients are billed to clients and all supplies are purchased on open account.

4. You determined that as of December 31, 1967 all receivables were for work completed in 1967, the technical supplies on hand were purchased in 1967, all liabilities were incurred in 1967, and no land, building or equipment was sold or retired in 1967.

Required:

a. The incorporators are concerned because the cash receipts and disbursements statement prepared by the bookkeeper and the income statement prepared by you do not agree and they ask that you explain their transactions for 1967 from an accountant's point of view. Your explanations should include the amounts of the transactions. Any supporting computations should be in good form. Do not consider income taxes. An income statement is not required.

Analyze and explain the following:

1. Changes in the amounts receivable from clients and prepayments by clients not billed in 1966.
2. Work completed in 1967, both billed and unbilled.
3. Changes in the technical supplies inventory and the amount due to suppliers.
4. Increase in land, building and equipment.

5. Increase in accumulated depreciation.
6. The $35,616 discounted note and accrued interest payable.
7. The $15,000 deferred salary payable.

b. Explain why an income statement prepared by a CPA and a statement of cash receipts and disbursements prepared by the bookkeeper would produce different results.

Number 7 (Estimated time—25 to 30 minutes)

In January 1961 the Apex Company requested and secured permission from the Commissioner of Internal Revenue to compute inventories under the last-in, first-out (LIFO) method as provided in Section 472 of the *Internal Revenue Code of 1954* and elected to determine inventory cost under the dollar-value method. Apex satisfied the Commissioner that cost could be accurately determined by use of an index number computed from a representative sample selected from the Company's single inventory pool. Apex elected to price subsequent inventory layers at year-end prices (LIFO base with FIFO increments) and also adopted this method for financial reporting purposes as required by IRC Section 472.

Required:

a. Why should inventories be included (1) in a statement of financial position and (2) in the computation of net income?

b. The *Internal Revenue Code* allows some accountable events to be considered differently for income tax reporting purposes and financial accounting purposes while other accountable events must be reported the same for both purposes. Discuss why it might be desirable to report some accountable events differently for financial accounting purposes than for income tax reporting purposes.

c. Discuss the ways and conditions under which the FIFO and LIFO inventory costing methods produce different inventory valuations. Do not discuss procedures for computing inventory cost.

d. The LIFO inventory costing method and the dollar-value LIFO inventory costing method will produce different inventory valuations if the composition of the inventory base changes. Explain why this is true.

e. Describe the similarities and differences of the dollar-value LIFO inventory method to be used by Apex and the base stock inventory method.

Examination, November, 1968

EXAMINATION IN ACCOUNTING PRACTICE—PART 1

November 6, 1968; 1:30 to 6:00 p.m.

GROUP I

All problems are required.

Number 1 (Estimated time—40 to 50 minutes)

Instructions

The following items pertain to the taxation of corporations. **Unless otherwise stated in the following questions, income was determined in accordance with generally accepted accounting principles and is income before federal income taxes.** Consider only the information given in the question in determining your answer.

Write your answers on a separate answer sheet for each of the following questions. The answers should be selected in accordance with the *Internal Revenue Code* and *Tax Regulations*. Select only one answer for each question.

An example of the manner in which the questions should be answered is shown in the following illustration:

Question

XX. Dobbs Corporation's income for 1967 was $200,000. An examination of the financial statements indicates that there was $25,000 of depreciation expense. The Corporation computes depreciation by the straight-line method on its financial statements and by the declining balance method for income tax reporting. Depreciation under the declining balance method totaled $37,000.

Taxable income was:

a. $225,000.
b. $212,000.
c. $188,000.
d. $175,000.
e. None of the above.

Answer Sheet

XX. c.

Questions to be Answered

1. Dyke Corporation's income for 1967 was $95,000. The Corporation received $20,000 in dividends from domestic non-affiliated corporations, paid $2,000 for real estate taxes on corporate property and paid interest of $1,000 on a bank loan. Taxable income was
   a. $95,000.
   b. $92,000.
   c. $89,000.
   d. $75,000.
   e. None of the above.

2. Vanson Corporation's income for 1967 was $100,000. The Corporation paid $3,000 for charitable contributions, received $1,000 interest income on notes from customers, and sustained a $5,000 loss from the sale of a machine purchased in 1964 and used in the business. Taxable income was
   a. $105,000.
   b. $100,000.
   c. $95,000.
   d. $91,000.
   e. None of the above.

3. Arken Corporation's income for 1967 was $40,000. The Corporation sustained a $10,000 loss on the sale of stock of a non-affiliated company and received $20,000 in dividends from domestic non-affiliated corporations. Taxable income was
   a. $50,000.
   b. $33,000.
   c. $10,000.
   d. $7,500.
   e. None of the above.

4. Vagt Corporation's income for 1967 was $240,000. The Corporation received $40,000 in dividends from domestic affiliated corporations. Vagt and the affiliated corporations were members of an affiliated group that elected to take a single surtax exemption, to take the maximum dividends received deduction, and not to file a consolidated income tax return. Taxable income was
   a. $240,000.
   b. $234,000.
   c. $206,000.
   d. $200,000.
   e. None of the above.

5. Valenti Corporation's income for 1967 was $100,000. The Corporation received $5,000 interest on State of Florida Bonds and made a $1,000 contribution to the United Fund to be used only to pay the cost of advertisements in newspapers listing all Valenti employees as contributors to the United Fund in 1966. Taxable income was

a. $105,000.
b. $100,000.
c. $95,000.
d. $94,000.
e. None of the above.

6. Valentine Corporation's income for 1967 was $50,000. The Corporation paid $5,000 in dividends on cumulative preferred stock and paid $3,000 for charitable contributions (not of an advertising nature). Taxable income was
a. $50,500.
b. $50,350.
c. $47,500.
d. $42,500.
e. None of the above.

7. Aken Corporation's income for 1967 was $100,000. Organization expenses of $36,000 incurred at the organization date two years earlier are being written off over a ten-year period on the financial statements and over the minimum period for tax purposes. Taxable income was
a. $103,600.
b. $100,000.
c. $96,400.
d. $92,800.
e. None of the above.

8. Bergen Corporation's income for 1967 was $100,000. The Corporation received $30,000 in dividends from domestic non-affiliated corporations and made a $5,000 contribution to the Boy Scouts. Taxable income was
a. $75,775.
b. $74,500.
c. $71,000.
d. $69,500.
e. None of the above.

9. Nestle Corporation's income for 1967 was $150,000. The Corporation had a $10,000 loss on the sale of buildings depreciated on the straight-line basis, a $5,000 gain on the sale of land on which the buildings were constructed and a $10,000 loss on the sale of stock of a non-affiliated corporation held more than six months. Taxable income was
a. $160,000.
b. $150,000.
c. $145,000.
d. $140,000.
e. None of the above.

10. Landingham Corporation issued 10,000 shares of $100 par value stock on January 1, 1960 for $120 per share. On May 1, 1967 it acquired 100 shares of its own stock for $135 per share. On December 13, 1967 when the stock was selling on the market for $147 per share, it sold 10 shares of the stock acquired on May 1 for $149 per share. As a result of the sale on December 13 Landingham Corporation had a
   a. Long-term capital gain of $49 per share.
   b. Long-term capital gain of $14 per share.
   c. Long-term capital gain of $12 per share.
   d. Short-term capital loss of $2 per share.
   e. None of the above.

11. Worthy Corporation is a personal holding company and its taxable income for 1967 was $100,000 upon which a tax of $41,500 was paid. The Corporation paid dividends of $10,000 in 1967 and contributions in excess of those allowable for income tax purposes totaled $12,000. Undistributed personal holding company income for 1967 was
   a. $58,500.
   b. $48,500.
   c. $46,500.
   d. $36,500.
   e. None of the above.

12. Zant Corporation sustained a $10,000 loss on the sale of stock of a non-affiliated corporation during 1967. The stock had been held for more than one year. The Corporation had no other capital asset transactions during the year. The correct treatment for this loss was to
   a. Deduct $10,000 from the current year's ordinary income.
   b. Deduct $1,000 and carry the remainder forward as a long-term capital loss.
   c. Deduct $1,000 and carry the remainder forward as a short-term capital loss.
   d. Carry $10,000 forward as a short-term capital loss.
   e. None of the above.

13. Van Dyke Corporation's income for 1967 was $260,000. Dividends received from domestic non-affiliated corporations totaled $300,000. Taxable income was
   a. $260,000.
   b. $255,000.
   c. $39,000.
   d. $5,000.
   e. None of the above.

14. George and Tom Gelder formed the Vander Corporation on July 1, 1967. George contributed $45,000 in cash and Tom contributed a building which he had purchased in 1963 for $55,000. The building had a basis of $46,000 and a

fair market value of $50,000 on the date of contribution. George and Tom were both issued stock with a fair market value of $50,000 to each. The basis of the building to Vander Corporation was

a. $55,000.
b. $50,000.
c. $46,000.
d. $45,000.
e. None of the above.

15. Vanity Corporation wishes to elect partnership-type taxation. Which of the following, if any, would prevent the election?

a. There is one nonresident alien stockholder.
b. It has ten shareholders.
c. It is a domestic corporation and not a member of an affiliated group.
d. One shareholder is an estate.
e. None of the above.

16. In 1967 Weimer Corporation had long-term capital gains of $15,000, long-term capital losses of $3,000, net short-term gains of $4,000, gains on the sale of Sec. 1245 property of $8,000 and losses on the sale of Sec. 1231 property of $2,000. The capital gains deduction for Weimer Corporation was

a. $8,000.
b. $7,000.
c. $6,000.
d. $5,000.
e. None of the above.

17. Vance Corporation's taxable income for 1967 was $150,000. The surtax exemption for the Corporation was

a. $150,000.
b. $100,000.
c. $50,000.
d. $—0—.
e. None of the above.

18. Vandiver Corporation issued at par $300,000 of 4 per cent bonds in 1960 and used the full proceeds to purchase machinery for use in the business for $350,000. On July 2, 1967 when the basis of the machinery was $310,000 the Corporation purchased all of the bonds issued in 1960 in the open market for $275,000 and elected to exclude the income from the discharge of this indebtedness from 1967 income. The basis of the machinery immediately after the election was

a. $325,000.
b. $310,000.
c. $285,000.
d. $275,000.
e. None of the above.

19. Van Duharte Corporation owns 100 per cent of two subsidiary corporations and is eligible to file a consolidated return. The group does not, however, and elects to take multiple surtax exemptions with each corporation filing a separate return. In doing so, the three corporations are subject to an additional tax of

a. 2 per cent on each surtax exemption.
b. 6 per cent on the total income of the three corporations.
c. 6 per cent of the total taxes of the three corporations.
d. 6 per cent on the first $25,000 income taxable to each of the three corporations.
e. None of the above.

20. Werner Corporation had a net loss for 1967 on its income tax return. After certain adjustments to the net loss, the net operating loss until exhausted may be

a. Carried back for three years and then forward for five years.
b. Carried forward for an unlimited period until exhausted.
c. Carried forward for the five future years.
d. Carried forward for three years.
e. None of the above.

Number 2 (Estimated time—45 to 55 minutes)

Modern Products Corporation, a manufacturer of molded plastic containers, determined in October 1968 that it needed cash to continue operations. The Corporation began negotiating for a one-month bank loan of $100,000 which would be discounted at 6 per cent per annum on November 1. In considering the loan the bank requested a projected income statement and a cash budget for the month of November.

The following information is available:

1. Sales were budgeted at 120,000 units per month in October 1968, December 1968 and January 1969 and at 90,000 units in November 1968.

The selling price is $2 per unit. Sales are billed on the 15th and last day of each month on terms of 2/10 net 30. Past experience indicates sales are even throughout the month and 50 per cent of the customers pay the billed amount within the discount period. The remainder pay at the end of 30 days, except for bad debts which average ½ per cent of gross sales. On its income statement the Corporation deducts from sales the estimated amounts for cash discounts on sales and losses on bad debts.

2. The inventory of finished goods on October 1 was 24,000 units. The finished goods inventory at the end of each month is to be maintained at 20 per cent of sales anticipated for the following month. There is no work in process.

3. The inventory of raw materials on October 1 was 22,800 pounds. At the end of each month the raw materials inventory is to be maintained at not less than 40 per cent of production requirements for the following month. Materials are purchased as needed in minimum quantities of 25,000 pounds per shipment. Raw material purchases of each month are paid in the next succeeding month on terms of net 30 days.

4. All salaries and wages are paid on the 15th and last day of each month for the period ending on the date of payment.

5. All manufacturing overhead and selling and administrative expenses are paid on the 10th of the month following the month in which incurred. Selling expenses are 10 per cent of gross sales. Administrative expenses, which include depreciation of $500 per month on office furniture and fixtures, total $33,000 per month.

6. The standard cost of a molded plastic container, based on "normal" production of 100,000 units per month, is as follows:

Materials—½ pound	$ .50
Labor	.40
Variable overhead	.20
Fixed overhead	.10
Total	$1.20

Fixed overhead includes depreciation on factory equipment of $4,000 per month. Over- or under-absorbed overhead is included in cost of sales.

7. The cash balance on November 1 is expected to be $10,000.

Required:

Prepare the following for Modern Products Corporation assuming the bank loan is granted. (Do not consider income taxes.)

a. Schedules computing inventory budgets by months for
   1. Finished goods production in units for October, November and December.
   2. Raw material purchases in pounds for October and November.

b. A projected income statement for the month of November.

c. A cash forecast for the month of November showing the opening balance, receipts (itemized by dates of collection), disbursements and balance at end of month.

Number 3 (Estimated time—45 to 55 minutes)

Gocon Corporation, a manufacturer of pressure devices, engaged you to examine the Corporation's financial statements for the year ended April 30, 1968. At that date the Corporation had an incomplete incentive fee contract for the fabrication of 60 pressure transducers at a target cost of $15,000 each.

The contract provided that Gocon would recover its total allowable cost of fabricating and delivering the pressure transducers and in addition would receive a fee of $90,000 to be adjusted upward or downward in accordance with incentive provisions for cost, quality and delivery. The composition of the fee of $90,000 follows:

Adjustment Factor	*Percentage of Target Cost of $900,000*	*Amount*
Cost	5.0%	$45,000
Quality	2.0	18,000
Delivery	3.0	27,000
Total	10.0%	$90,000

The following information is available for the contract and Gocon's performance:

1. The incentive provisions of the contract require that Gocon's fee shall be increased by ten cents for every dollar by which Gocon's total allowable cost is less than the target cost or decreased by fifteen cents for every dollar by which the total allowable cost exceeds the target cost.

As of April 30, 1968 total allowable costs (including pre-production and manufacturing costs and general and administrative expenses) incurred by Gocon on the contract aggregated $804,000 and additional allowable costs required to complete all work on the contract were estimated at $72,000.

2. The contract provides that completed units should measure from 50,000 to 60,000 pounds of pressure and that the quality fee is established on this basis. Units measuring below 40,000 pounds of pressure are not acceptable. The incentive provision requires that the fee be adjusted for each unit which measures outside the specified range as follows:

Pressure Measurement In Pounds		*Adjustment per Unit to Fee (Stated as a Percentage of Target Cost)*	*Adjusted Quality Fee Per Unit*
At Least	*But Less Than*		
80,000	—	+0.75%	2.75%
70,000	80,000	+0.50%	2.50%
60,000	70,000	+0.25%	2.25%
40,000	50,000	—0.40%	1.60%

3. The 3 per cent delivery fee is based on the scheduled delivery of 20 units in each of the months of February, March and April, 1968. The incentive provisions specify that Gocon will collect 4 per cent (3 per cent plus 1 per cent additional) of the target cost per unit for each unit delivered prior to the scheduled month and will collect 0.75 per cent (3 per cent less 2.25 per cent penalty) of the target cost per unit for each unit delivered subsequent to the month scheduled for delivery.

4. As of April 30, 1968 Gocon had delivered 44 units which were tested and accepted as follows:

1968 Delivery Date	*Total Number of Units*	*Pressure Test in Pounds*				
		40,000-49,999	50,000-59,999	60,000-69,999	70,000-79,999	80,000-89,999
February 2. .	26	2	6	12	6	
March 29 . . .	18			2	6	10
Totals . . .	44	2	6	14	12	10

The Corporation expects to deliver the remaining 16 units during May 1968 and estimates that these units will test at target quality.

Required:

a. Prepare a schedule presenting the computation of the total amount that should ultimately be received on the contract. Supporting computations for the incentive fee for cost, quality and delivery should be in good form.

b. Assume that Gocon used the completed contract method and that as of April 30, 1968 $500,000 in progress payments had been received on the contract. Show how this contract would be presented on Gocon's April 30, 1968 balance sheet, including a footnote if needed.

Number 4 (Estimated time—40 to 50 minutes)

You are examining the financial statements of Conrad Sales Company for the year ended December 31, 1967. Conrad has not had an audit before. Sales are made from Conrad's Home Office, a newly opened Branch Office and through consignees. Shipments to consignees are recorded at Conrad's cost by charging a consignment account and crediting the Home Office Inventory account. Conrad bears the cost of shipping to consignees.

A general ledger trial balance as of December 31, 1967 appears on page 284.

The following information was also available:

1. An inventory taken at the Home Office on December 31, 1967 had a cost of $196,200 and a fair market value of $198,300. A perpetual inventory system is maintained.

2. Merchandise costing $149,000 was consigned to Nelson on September 1, 1967 and was shipped to Nelson directly from the supplier's factory. On December 31, 1967 Nelson reported sales totaling $50,000 since September 1 and claimed $10,000 for his commission of 20 per cent of sales. Nelson also claimed reimbursement of $5,000 for freight paid September 1 and $500 for advertising expense to be borne by Conrad. Nelson applied the $34,500 balance due to Conrad against $40,000 owed by Conrad for merchandise purchased from Nelson (the $40,000 was included in Conrad's accounts payable at December 31, 1967). Nelson's inventory of consigned merchandise amounted to $119,200 at original cost as determined by Conrad at December 31, 1967.

3. On November 10, 1967 Conrad signed an agreement with Towers who agreed to become a consignee on January 31, 1968. In November 1967 Conrad prepaid expenses of $1,200 related to the Towers agreement and charged General and Administrative Expenses-Consignment for the disbursement.

4. The Investments account balance at December 31, 1967 in the general ledger was composed of the following:

Cost of 40,000 shares of Conrad treasury stock purchased in 1965	$ 68,000
Marketable securities at cost (market value December 31, 1967, $82,000)	80,000
Cost of exclusive distribution franchises with unlimited lives	17,000
Total	$165,000

Conrad Sales Company
GENERAL LEDGER TRIAL BALANCE
Year Ended December 31, 1967

Accounts	*General Ledger Trial Balance* Debit	Credit
Cash	$ 65,400	
Accounts receivable—home office	311,500	
Allowance for bad debts		$ 9,000
Merchandise inventory—home office	200,600	
Merchandise inventory—branch	100,000	
Consignment to Nelson	149,000	
Investments	165,000	
Prepaid incentive bonus	20,000	
Prepaid expenses	32,100	
Other assets	164,000	
Accounts payable		205,600
Accrued incentive bonus		35,000
Capital stock, $1 par value		500,000
Retained earnings at beginning of year		366,600
Sales—home office		1,022,500
Sales—consignment		21,300
Cost of sales—home office	738,600	
Cost of sales—consignment	8,200	
Selling expenses—home office	92,400	
Selling expenses—branch	9,600	
Selling expenses—consignment	5,600	
General and administrative expenses—home office	91,000	
General and administrative expenses—branch	4,100	
General and administrative expenses—consignment	2,900	
Totals	$2,160,000	$2,160,000

5. Conrad paid $20,000 for incentive bonus on December 22, 1967 before the bonus was due. The entire bonus of $35,000 was accrued at December 31, 1967 and the balance of $15,000 was paid on January 15, 1968.

6. Other Assets included $10,000 of market survey costs for a sales project undertaken and abandoned in 1967, $1,000 of deposits held by utility companies and $153,000 of net fixed assets. Examination of fixed asset records revealed that Conrad deducted the correct amount of depreciation each year from the recorded cost of fixed assets. The $153,000 was comprised of original costs of $53,000 for land, $100,000 for a building and $28,000 for furniture and equipment less accumulated depreciation of $22,000 on the building and $6,000 on the furniture and equipment.

7. On September 15, 1967 Conrad established a Branch Office and shipped to it merchandise having a retail value of $140,000 (140 per cent of Conrad's cost). At December 31, 1967 the Branch Office inventory was $56,000 priced at

retail value. The Branch Office reported 1967 sales of $84,000, of which $50,400 had been collected by the branch and represented cash in transit to Conrad at December 31 and $33,600 was receivable from branch customers. The Branch Office considered all its accounts collectible at December 31, 1967. Branch Office administrative expenses totaling $4,100 were paid by Conrad in 1967 and charged to the General and Administrative Expenses-Branch account.

8. The Home Office Accounts Receivable consisted of the following:

Various small 1966 balances in dispute	$ 2,000
Account balances of bankrupt customers from whom no additional amounts will be collected	9,500
Remaining accounts for which it is estimated 3 per cent will prove uncollectible	300,000
Total	$311,500

Bad Debts Expense of $4,000 was included in the General and Administrative Expenses-Home Office account at December 31, 1967.

Required:

Prepare a worksheet to adjust the accounts of Conrad Sales Company for the year ended December 31, 1967. Formal adjusting journal entries and financial statements are not required. Supporting computations should be in good form. Ignore income taxes.

GROUP II

Estimated time—50 to 60 minutes

Solve only one of the two problems in this group.
If both are solved, only the first will be considered.

Number 5

Food Products, Inc., an audit client, posed the following problem to your CPA firm and requested guidelines which can be applied in the future to obtain the largest net income.

A Food Products plant on the coast produces a food product and ships its production of 10,000 units per day by air in an airplane owned by Food Products. The area is sometimes fogbound and shipment can then be made only by rail. The plant does not operate unless shipments are made. Extra costs of preparation for rail shipment reduce the marginal contribution of this product from $.40 per unit to $.18 per unit and there is an additional fixed cost of $3,100 for modification of packaging facilities to convert to rail shipment (incurred only once per conversion).

The fog may last for several days and Food Products normally starts shipping by rail only after rail shipments become necessary to meet commitments to customers.

A meteorological report reveals that during the past 10 years the area has been fogbound 250 times for 1 day and that fog continued 100 times for a second consecutive day, 40 times for a third consecutive day, 20 times for a fourth consecutive day and 10 times for a fifth consecutive day. Occasions and length of fog were both random. Fog never continued more than 5 days and there were never 2 separate occurrences of fog in any 6-day period.

Required:

a. Prepare a schedule presenting the computation of the daily marginal contribution (ignore fixed conversion cost)

1. When there is no fog and shipment is made by air.
2. When there is fog and shipment is made by rail.

b. Prepare a schedule presenting the computation of the probabilities of the possible combinations of foggy and clear weather on the days following a fogbound day. Your schedule should show the probability that, if fog first occurs on a particular day,

1. The next 4 days will be foggy.
2. The next 3 days will be foggy and day 5 will be clear.
3. The next 2 days will be foggy and days 4 and 5 will be clear.
4. The next day will be foggy and days 3, 4 and 5 will be clear.
5. The next 4 days will be clear.

c. Assume you determine it is probable that it would be unprofitable to start shipping by rail on either the fourth or fifth consecutive foggy day. Prepare a schedule presenting the computation of the probable marginal income or loss that should be expected from rail shipments if rail shipments were started on the third consecutive foggy day and the probability that the next 2 days will be foggy is .25, the probability that the next day will be foggy and day 5 will be clear is .25, and the probability that the next 2 days will be clear is .50.

d. In this engagement the CPA should consider the reliability of the data upon which he bases his conclusions. What questions should he consider regarding

1. Financial data reliability?
2. Meteorological data reliability?

Number 6

A newly elected board of directors of Central Hospital, a nonprofit corporation, decided that effective January 1, 1968

(a) the existing general ledger balances are to be properly adjusted and allocated to three separate funds (General Fund, John Central Endowment Fund and Plant Fund),

(b) the totals of the John Central Endowment Fund and the Allowance For Accumulated Depreciation are to be fully invested in securities, and

(c) all accounts are to be maintained in accordance with the principles of fund accounting. The board engaged you to determine the proper account balances for each of the funds.

The balances in the general ledger at January 1, 1968 were:

	Debit	*Credit*
Cash	$ 50,000	
Investment in U. S. Treasury bills	105,000	
Investment in common stock	417,000	
Interest receivable	4,000	
Accounts receivable	40,000	
Inventory	25,000	
Land	407,000	
Building	245,000	
Equipment	283,000	
Allowance for depreciation		$ 376,000
Accounts payable		70,000
Bank loan		150,000
John Central Endowment Fund		119,500
Surplus		860,500
Totals	$1,576,000	$1,576,000

The following additional information is available:

1. Under the terms of the will of John Central, founder of the hospital, "the principal of the bequest is to be fully invested in trust forevermore in mortgages secured by productive real estate in Central City and/or in U.S. Government securities . . . and the income therefrom is to be used to defray current expenses."

2. The John Central Endowment Fund account balance consists of the following:

Cash received in 1871 by bequest from John Central	$ 81,500
Net gains realized from 1926 through 1959 from the sale of real estate acquired in mortgage foreclosures	23,500
Income received from 1960 through 1967 from 90-day U.S. Treasury Bill investments	14,500
Balance per general ledger on January 1, 1968	$119,500

3. The Land account balance was composed of:

1890 appraisal of land at $10,000 and building at $5,000 received by donation at that time. (The building was demolished in 1910.)	$ 15,000
Appraisal increase based on insured value in land title policies issued in 1927	380,000
Landscaping costs for trees planted	12,000
Balance per general ledger on January 1, 1968	$407,000

4. The Building account balance was composed of:

Cost of present hospital building completed in January 1927 when the hospital commenced operations	$300,000
Adjustment to record appraised value of building in 1937	(100,000)
Cost of elevator installed in hospital building in January 1953	45,000
Balance per general ledger on January 1, 1968	$245,000

The estimated useful lives of the hospital building and the elevator when new were 50 years and 20 years, respectively.

5. The hospital's equipment was inventoried on January 1, 1968. The cost of the inventory agreed with the Equipment account balance in the general ledger. The Allowance For Accumulated Depreciation account at January 1, 1968 included $158,250 applicable to equipment and that amount was approved by the board of directors as being accurate. All depreciation is computed on a straight-line basis.

6. A bank loan was obtained to finance the cost of new operating room equipment purchased in 1964. Interest on the loan was paid to December 31, 1967.

Required:

Prepare a worksheet to present the adjustments necessary to restate the general ledger account balances properly and to distribute the adjusted balances to establish the required fund accounts. Formal journal entries are not required. Computations should be in good form and should be referenced to the worksheet adjustments which they support. In addition to trial balance columns, the following columnar headings are recommended for your worksheet:

Adjustments		*General Fund*		*John Central Endowment Fund*		*Plant Fund*	
Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*

EXAMINATION IN ACCOUNTING PRACTICE—PART II

November 7, 1968; 1:30 to 6:00 p.m.

All problems are required.

Number 1 (Estimated time—40 to 50 minutes)

Adair, Blinker, and Coe formed a partnership on January 2, 1967 under the name of Abcoe Engineering Services. Adair contributed $10,000 in cash, Blinker contributed $5,000 in cash and securities worth $5,000 (which he had purchased for $3,000 on September 30, 1966) and Coe contributed office furniture and equipment worth $10,000. Coe had purchased the office furniture and equipment for $20,000 during 1962, depreciated it under the double-declining balance method for a 10-year life and it had an adjusted basis to him of $5,240 at the date of contribution. Each partner's capital account was credited $10,000.

The partnership agreement stipulated the three partners would receive salaries, interest would be paid on their capital accounts and any remaining net income or loss would be divided equally. The agreement also provided that for purposes of income tax reporting the first $2,000 of taxable gain from the sale of securities would be allocated to Blinker, that all depreciation on the contributed office furniture and equipment would be allocated to Adair and Blinker, and the first $4,760 of taxable gain from the sale of the office furniture and equipment would be allocated to Coe.

The following information is also available:

1. Net income from all sources on the partnership income statement was $75,000 before allocations to the partners for salaries and interest. Salaries and interest for 1967 determined in accordance with the partnership agreement were:

	Salary	*Interest*
Adair	$18,000	$1,000
Blinker	15,000	1,100
Coe	12,000	900

2. The securities contributed by Blinker were sold March 31, 1967 for $5,900. Dividends received on these securities before they were sold amounted to $60.

3. On June 30, 1967 Abcoe sold for its book value of $9,500 the office furniture and equipment contributed by Coe. The same day Abcoe moved to a new building constructed at a cost of $40,000 and furnished with new furniture and

equipment which cost $30,000. In the financial statements 1967 depreciation of the building was $400 (10 per cent salvage, 45-year life) and 1967 depreciation of the new furniture and equipment was $1,350 (10 per cent salvage, 10-year life). The partners wish to deduct the maximum depreciation allowable, including additional first-year depreciation, for income tax purposes.

Required:

a. Prepare a schedule computing the ordinary income (or loss) which should be reported by Abcoe Engineering Services in its partnership income tax return for 1967. Start your schedule with the 1967 net income for financial statement purposes of $75,000 and itemize differences which must be considered to arrive at ordinary income to be shown in the partnership income tax return. Supporting computations should be in good form.

b. Prepare a schedule presenting each partner's distributable share of items to be reported for income tax purposes separately by each partner as a result of partnership transactions during 1967.

Number 2 (Estimated time—50 to 60 minutes)

Lopez Department Store converted from the conventional retail method to the LIFO retail method on January 1, 1966 and is now considering converting to the dollar-value LIFO inventory method. Management requested during your examination of the financial statements for the year ended December 31, 1967 that you furnish a summary showing certain computations of inventory costs for the past three years.

Available information follows:

1. The inventory at January 1, 1965 had a retail value of $45,000 and a cost of $27,500 based on the conventional retail method.

2. Transactions during 1965 were as follows:

	Cost	*Retail*
Gross purchases	$282,000	$490,000
Purchase returns	6,500	10,000
Purchase discounts	5,000	
Gross sales		492,000
Sales returns		5,000
Employee discounts		3,000
Freight inward	26,500	
Net markups		25,000
Net markdowns		10,000

3. The retail value of the December 31, 1966 inventory was $56,100, the cost ratio for 1966 under the LIFO retail method was 62 per cent and the regional price index was 102 per cent of the January 1, 1966 price level.

4. The retail value of the December 31, 1967 inventory was $48,300, the cost ratio for 1967 under the LIFO retail method was 61 per cent and the regional price index was 105 per cent of the January 1, 1966 price level.

Required:

a. Prepare a schedule showing the computation of the cost of inventory on hand at December 31, 1965 based on the conventional retail method.

b. Prepare a schedule showing the computation of the cost of inventory on hand at the store on December 31, 1965 based on the LIFO retail method. Lopez Department Store does not consider beginning inventories in computing its LIFO retail cost ratio. Assume that the retail value of the December 31, 1965 inventory was $50,000.

c. Without prejudice to your solution to part "b," assume that you computed the December 31, 1965 inventory (retail value $50,000) under the LIFO retail method at a cost of $28,000. Prepare a schedule showing the computations of the cost of the store's 1966 and 1967 year-end inventories under the dollar-value LIFO method.

Number 3 (Estimated time—40 to 50 minutes)

Conti Pharmaceutical Company processes a single compound-product known as NULAX and uses a standard cost accounting system. The process requires preparation and blending of three materials in large batches with a variation from the standard mixture sometimes necessary to maintain quality. Conti's cost accountant became ill at the end of October 1968 and you were engaged to determine standard costs of October production and explain any differences between actual and standard costs for the month. The following information is available for the Blending Department:

1. The standard cost card for a 500-pound batch shows the following standard costs:

	Quantity	*Price*	*Total Cost*	
Materials:				
Mucilloid	250 pounds	$.14	$35	
Dextrose	200 pounds	.09	18	
Ingredients	50 pounds	.08	4	
Total per batch	500 pounds			$ 57
Labor:				
Preparation and blending	10 hours	$3.00		30
Overhead:				
Variable	10 hours	$1.00	10	
Fixed	10 hours	.30	3	13
Total standard cost per 500-pound batch				$100

2. During October 410 batches of 500 pounds each of the finished compound were completed and transferred to the Packaging Department.

3. Blending Department inventories totaled 6,000 pounds at the beginning of the month and 9,000 pounds at the end of the month (assume both inventories were completely processed but not transferred and consisted of materials in their standard proportions).

Inventories are carried in the accounts at standard cost prices.

4. During the month of October the following materials were purchased and put into production:

	Pounds	*Price*	*Total Cost*
Mucilloid	114,400	$.17	$19,448
Dextrose	85,800	.11	9,438
Ingredients	19,800	.07	1,386
Totals	220,000		$30,272

5. Wages paid for 4,212 hours of direct labor at $3.25 per hour amounted to $13,689.

6. Actual overhead costs for the month totaled $5,519.

7. The standards were established for a normal production volume of 200,000 pounds (400 batches) of NULAX per month. At this level of production variable factory overhead was budgeted at $4,000 and fixed factory overhead was budgeted at $1,200.

Required:

a. Prepare a schedule presenting the computation for the Blending Department of:

1. October production in both pounds and batches.
2. The standard cost of October production itemized by components of materials, labor and overhead.

b. Prepare schedules computing the differences between actual and standard costs and analyzing the differences as:

1. Materials variances (for each material) caused by
   (a) Price differences.
   (b) Usage differences.
2. Labor variances caused by
   (a) Rate difference.
   (b) Efficiency difference.
3. Overhead variances caused by
   (a) Controllable factors.
   (b) Volume factors.

c. Explain how the materials variances arising from usage differences could be further analyzed (no computations are necessary).

Number 4 (Estimated time—50 to 60 minutes)

Calor Drilling Company applied for a bank loan to finance the purchase of a new drilling rig. The bank required Calor to submit financial statements audited by a CPA and Calor engaged you. A trial balance as of December 31, 1967 taken from Calor's general ledger, which is maintained on the cash basis, appears below:

Calor Drilling Company

TRIAL BALANCE (CASH BASIS)

December 31, 1967

Accounts	*Debit*	*Credit*
Cash	$ 145,000	
Productive oil leases	100,000	
Allowance for depletion		$ 137,500
Land, building and equipment	1,800,000	
Allowance for depreciation		800,000
Employees' withholding taxes		5,500
Notes payable (due 1968)		250,000
Common stock ($10 par value)		300,000
Retained earnings		252,000
Drilling revenue		1,200,000
Salaries and wages	381,000	
Payroll taxes	24,000	
Pipe and supplies	245,000	
Insurance	44,000	
Depreciation	300,000	
Interest	1,000	
Other expenses	50,000	
Oil royalties		200,000
Depletion	55,000	
Total	$3,145,000	$3,145,000

The following information had not been recorded at the dates indicated:

	December 31	
	1966	*1967*
Accounts receivable from drilling contracts (1)	$150,000	$192,000
Drilling contracts included in accounts receivable for the cost of unproductive oil leases (1)	25,000	22,000
Estimated uncollectible accounts (1)	6,000	8,000
Prepaid insurance (2)	12,000	70,000
Accounts payable (3)	28,000	67,000
Insurance note payable (2)		40,000
Accrued expenses payable:		
Salaries and wages	11,000	4,000
Payroll taxes (4)	1,200	500
Interest (4)	900	2,200

1. Accounts receivable include all unpaid drilling contracts. Occasionally an interest in a lease being drilled is taken as the fee on a drilling contract and the fee is included in accounts receivable. Productive leases are recorded by journal entry at cost to charge off the fractional working interest of intangible drilling costs to expense and capitalize the balance of tangible and intangible drilling costs as assets and the fee as drilling revenue. The $25,000 of unproductive leases and $6,000 of uncollectible accounts from 1966 were removed from accounts receivable during 1967. Leases are abandoned when they are drilled and found to be unproductive.

2. All insurance policies were renewed as 3-year policies on July 1, 1967 with premiums aggregating $84,000. A payment of $44,000 was made and a $40,000 note payable July 1, 1968 was signed for the balance.

3. Accounts payable were for pipe and supplies which were purchased as needed for use. No inventory was maintained.

4. Accrued expenses included the employer's portion of all payroll taxes and accrued interest payable on all notes.

Additional information includes the following:

5. On December 29, 1967 Calor issued 1,000 shares of common stock in exchange for a productive oil lease with a fair market value of $15,000 and made no entry to record the transaction.

6. Depletion on oil leases owned was recorded under the statutory depletion method at 27½ per cent of the oil royalties received from the leases. It was estimated that 75 per cent of the oil reserves were still recoverable at December 31, 1967 and 84 per cent were recoverable at December 31, 1966 from the $100,000 of leases owned during 1966 and 1967.

7. Accelerated depreciation was recorded in conformity with income tax reporting. For its financial statements Calor would like to compute depreciation under the straight-line method. Accumulated depreciation under the straight-line method would have been $370,000 at December 31, 1966 and $560,000 at December 31, 1967.

8. Income tax returns had been examined through 1966 and accepted as filed. Income tax expense for 1966 amounted to $7,500 and was paid in 1967 and charged to Other Expenses. Payments totaling $36,000 on 1967 estimated income taxes were also charged to Other Expenses. Income tax expense for 1967 on the accrual basis amounted to $235,000. Deferred income taxes payable amounted to $99,000 at December 31, 1966 and $133,000 at December 31, 1967 (assume the amounts stated for income taxes are correct).

Required:

Prepare a worksheet for the preparation of Calor Drilling Company's financial statements at December 31, 1967 on the accrual basis. Number your adjustments on the worksheet to correspond with the numbers for the information given. Supporting computations should be in good form. Formal adjusting journal entries and financial statements are not required.

Number 5 (Estimated time—40 to 50 minutes)

Southwest Company, your audit client, requested your assistance in deciding whether the Company should continue to manufacture or should purchase mansers, a component of their major product. The annual requirement for mansers is 10,000 units and the part is available from an outside supplier in any quantity at $5 per unit.

The following information is available:

1. The Machining Department starts and substantially completes mansers and minor finishing is completed by the use of direct labor in the Finishing Department. The Assembly Department places mansers in the finished product.
2. Machinery used to produce mansers could be sold for its book value of $15,000 and the proceeds invested at 6 per cent per year if the mansers were purchased. Property taxes and insurance would decrease $300 per year if the machinery were sold. The machinery has a remaining life of 10 years with no estimated salvage value.
3. The Machining Department is devoted about 25 per cent to the production of mansers but labor and some other costs for mansers in this department could be reduced without affecting other operations. The Finishing Department's costs include direct labor totaling $800 devoted to mansers. If mansers were not manufactured one half of the resulting available direct labor would be used as indirect labor and the remaining one half would result in paid idle time of employees.
4. In 1967 when 10,000 mansers were produced, pertinent Machining Department costs were:

	Total Costs	*Costs Allocated to Mansers*
Materials	$95,000	$24,200
Direct labor	39,400	12,200
Indirect labor	20,600	7,800
Heat and light	12,000	3,000
Depreciation	6,000	1,500
Property taxes and insurance	15,000	3,750
Production supplies	4,000	800

5. In addition the Machining Department total costs included $18,300 payroll taxes and other benefits.
6. Overhead allocated on the basis of 200 per cent of direct labor cost was $40,000 for the Finishing Department and $20,000 for the Assembly Department in 1967. Overhead in these Departments is 25 per cent fixed and 75 per cent variable.
7. If mansers are purchased, Southwest will incur added costs of $.45 per unit for freight and $3,000 per year for receiving, handling and inspection of the product.

Required:

a. Prepare a schedule comparing Southwest's total annual cost of mansers if manufactured with their annual cost if purchased. (Ignore income taxes.)

b. Without regard to your solution to part "a" assume the total annual cost of mansers if manufactured and if purchased were both $60,000. Compute the annual net cash outflow (1) if mansers are manufactured and (2) if mansers are purchased. (Ignore income taxes.)

c. Southwest's management must consider working capital requirements in deciding whether to manufacture or to purchase mansers. Explain the working capital requirements which should be considered.

EXAMINATION IN AUDITING

November 7, 1968; 8:30 a.m. to 12:00 m.

All questions are required.

Number 1 (Estimated time—25 to 30 minutes)

Instructions

Each of the numbered statements following is true or false. Write on a separate answer sheet whether each statement is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

An example of the manner in which the question should be answered is shown in the following illustration:

Question

W. A mean is a computed average.
X. It is impossible to estimate the mean of a population from the mean of a sample drawn from that population.
Y. Input-output devices are not part of a computer's hardware.
Z. Debugging is the process of locating and correcting errors in a computer program.

Answer Sheet

W. True	Y. False
X. False	Z. True

Questions to be Answered

The first ten statements following apply to unrestricted random sampling with replacement, a sampling technique which may be employed by an auditor under proper circumstances.

1. If the auditor wishes to use a table of random digits to select a random sample, he must first find a table conforming to the numbering employed by the items in the population he wishes to sample.
2. If a usable digit appears more than once in the table of random digits during the selection of the sample, the item should be included in the sample only once and another digit selected from the table.

3. A preliminary random sample of at least 30 items would have to be discarded if it produced one item disproportionately large in relation to the other items selected.
4. The effect of the inclusion by chance of a very large or very small item in a random sample can be lessened by increasing the size of the sample.
5. The reliability specified by the auditor for a sample estimate expresses the degree of confidence that the true value will be within the precision limits determined.
6. The standard deviation is a measure of variability of items in the universe.
7. Variability of items in the population is a factor which usually causes a sample mean and a population mean to be different.
8. It is necessary to determine the true standard deviation for a population in order to determine the size of the sample to be drawn from that population.
9. The standard error of the mean will always be less than the estimated standard deviation computed from a sample estimate.
10. The standard error of the mean increases as the size of the sample increases.

An auditor should be familiar with the terminology employed in electronic data processing even though he may not utilize an electronic computer in conducting an examination. The next ten statements following contain some of the terminology so employed.

11. An auditor would utilize software if he uses the computer to perform audit steps.
12. Most accounting applications utilize fixed point rather than floating point arithmetic.
13. A compiler is part of the hardware of a computer installation.
14. A program loading routine is a detailed written instruction to the computer operator listing the exact sequence for processing a production run.
15. Data movement controls are internal equipment controls to ensure that all data are properly transferred.
16. A limit test is a test written into a computer program to determine that management's policies are not violated while data are being processed.
17. A completeness test is an internal equipment control to test whether or not all transactions have been processed.
18. The central processing unit of a computer installation does not include peripheral equipment.
19. One of the characteristics of online realtime processing is that inputs are available at random.
20. Byte is another name for bit.

Number 2 (Estimated time—25 to 30 minutes)

Jerome Paper Company engaged you to review its internal control system. Jerome does not prelist cash receipts before they are recorded and has other weaknesses in processing collections of trade receivables, the Company's largest asset. In discussing the matter with the controller, you find he is chiefly interested in economy when he assigns duties to the 15 office personnel. He feels the main considerations are that the work should be done by people who are most familiar with it, capable of doing it and available when it has to be done.

The controller says he has excellent control over trade receivables because receivables are pledged as security for a continually renewable bank loan and the bank sends out positive confirmation requests occasionally, based on a list of pledged receivables furnished by the Company each week. You learn that the bank's internal auditor is satisfied if he gets an acceptable response on 70 per cent of his requests.

Required:

a. Explain how prelisting of cash receipts strengthens internal control over cash.

b. Assume that an employee handles cash receipts from trade customers before they are recorded. List the duties which that employee should not do to withhold from him the opportunity to conceal embezzlement of cash receipts.

c. 1. What are the implications to a CPA if during his examination of accounts receivable some of a client's trade customers do not respond to his request for positive confirmation of their accounts?
2. Should the CPA send second requests? Why?
3. What auditing steps should a CPA perform if there is no response to a second request for a positive confirmation?

Number 3 (Estimated time—25 to 30 minutes)

You were in the final stages of your examination of the financial statements of Ozine Corporation for the year ended December 31, 1967 when you were consulted by the Corporation's president who believes there is no point to your examining the 1968 voucher register and testing data in support of 1968 entries. He stated that (a) bills pertaining to 1967 which were received too late to be included in the December voucher register were recorded as of the year end by the Corporation by journal entry, (b) the internal auditor made tests after the year end and (c) he would furnish you with a letter certifying that there were no unrecorded liabilities.

Required:

a. Should a CPA's test for unrecorded liabilities be affected by the fact that the client made a journal entry to record 1967 bills which were received late? Explain.

b. Should a CPA's test for unrecorded liabilities be affected by the fact that a letter is obtained in which a responsible management official certifies that to the best of his knowledge all liabilities have been recorded? Explain.

c. Should a CPA's test for unrecorded liabilities be eliminated or reduced because of the internal audit tests? Explain.

d. Assume that the Corporation, which handled some government contracts, had no internal auditor but that an auditor for a federal agency spent three weeks auditing the records and was just completing his work at this time. How would the CPA's unrecorded liability test be affected by the work of the auditor for a federal agency?

e. What sources in addition to the 1968 voucher register should the CPA consider to locate possible unrecorded liabilities?

Number 4 (Estimated time—25 to 30 minutes)

You are meeting with executives of Cooper Cosmetics Corporation to arrange your firm's engagement to examine the Corporation's financial statements for the year ending December 31, 1968. One executive suggested that the audit work be divided among three audit staff members so one man would examine asset accounts, a second would examine liability accounts and the third would examine income and expense accounts to minimize audit time, avoid duplication of staff effort and curtail interference with company operations.

Advertising is the Corporation's largest expense and the advertising manager suggested that a staff member of your firm whose uncle owns the advertising agency which handles the Corporation's advertising be assigned to examine the Advertising Expense account. The staff member has a thorough knowledge of the rather complex contract between Cooper Cosmetics and the advertising agency on which Cooper's advertising costs are based.

Required:

a. To what extent should a CPA follow his client's suggestions for the conduct of an audit? Discuss.

b. List and discuss the reasons why audit work should not be assigned solely according to asset, liability and income and expense categories.

c. Should the staff member of your CPA firm whose uncle owns the advertising agency be assigned to examine advertising costs? Discuss.

Number 5 (Estimated time—25 to 30 minutes)

On January 10, 1968 you were engaged to make an examination of the financial statements of Kahl Equipment Corporation for the year ended December 31, 1967. Kahl has sold trucks and truck parts and accessories for many years, but has never had an audit. Kahl maintains good perpetual records for all inventories and takes a complete physical inventory each December 31.

The Parts Inventory account includes the $2,500 cost of obsolete parts. Kahl's executives acknowledge these parts have been worthless for several years but they have continued to carry the cost as an asset. The amount of $2,500 is material in relation to 1967 net income and year-end inventories but not material in relation to total assets or capital at December 31, 1967.

Required:

a. List the procedures you would add to your inventory audit program for new trucks because you did not observe the physical inventory taken by the Corporation as of December 31, 1967.

b. Should the $2,500 of obsolete parts be carried in inventory as an asset? Discuss.

c. Assume your alternative auditing procedures satisfy you as to the Corporation's December 31, 1967 inventory but that you were unable to apply these alternative procedures to the December 31, 1966 inventory. Discuss (ignoring the obsolete parts) the effect this would have on your auditor's report in (1) the scope (or middle) paragraph and (2) the opinion paragraph.

Number 6 (Estimated time—25 to 30 minutes)

You were engaged to examine Barnes Corporation's financial statements for the year just ended. The CPA firm previously engaged declined to make the examination because a son of one of the CPA firm's partners received a material amount of Barnes Corporation common stock in exchange for engineering services rendered to the Corporation. The partner in the CPA firm advises his son in business affairs but does not own an interest in his son's engineering firm and had not participated in this examination in past years. Another of the CPA firm's 15 partners would have been in charge of this engagement.

This new client wants to receive three different reports from you. In the past the stockholders have considered and discussed the Corporation's annual report containing the financial statements and the auditor's opinion at their annual meeting. Because of the shortage of time before the stockholders' meeting, Corporation executives are willing to accept (1) your report containing unaudited statements to be used for the meeting and (2) your final report after your examination is complete. Thereafter, the client would like to receive (3) a report containing a forecast of the Corporation's 1968-70 operations.

Required:

a. Should the CPA firm previously engaged by Barnes Corporation have declined the examination of the financial statements for the year just ended? Discuss the ethical issues involved.

b. Discuss the issues in the client's request that you render unaudited financial statements prior to rendering your final report.

c. What are the issues for a CPA in rendering a report containing a forecast of a client's future operations? Discuss.

Number 7 (Estimated time—25 to 30 minutes)

During your audit of the 1967 financial statements of Longwood, Inc. you find a new account titled "Miscellaneous Assets." Your examination reveals that in 1967 Longwood, Inc. began investing surplus cash in marketable securities and the Corporation's bookkeeper entered all transactions he believed related to investments in this account. Information summarized from the Miscellaneous Assets account appears below:

Longwood, Inc.
INFORMATION SUMMARIZED FROM THE MISCELLANEOUS ASSETS ACCOUNT
For the Year Ended December 31, 1967

Date 1967		*Folio*	*Debit*	*Credit*
	Compudata common stock			
Mar. 31	Purchased 500 shares @ 48	*CD*	$24,000	
July 31	Received cash dividend of $2 per share..	*CR*		$ 1,000
July 31	Sold 100 shares @ 60	*CR*		6,000
Nov. 15	Pledged 100 shares as security for $4,000 bank loan payable February 15, 1968..	*CR*		4,000
Nov. 30	Received 150 shares by donation from stockholder whose cost in 1960 was $10 per share	*JE*	1,500	
	Standard Atomic common stock			
Mar. 31	Purchased 900 shares @ 26	*CD*	23,400	
June 30	Received dividend ($.25 per share in cash and 1 share Standard Atomic preferred for each 5 shares common owned)	*CR*		225
	Standard Atomic preferred stock			
June 30	Received 180 shares as stock dividend on Standard Atomic common	*MEMO*		
July 31	Sold 80 shares @ 17	*CR*		1,360
	Interstate Airlines bonds (due November 30, 1977 with interest at 6% payable May 31 and November 30)			
June 30	Purchased 25 $1,000 bonds @ 102	*CD*	25,625	
Nov. 30	Received interest due	*CR*		750
Nov. 30	Accumulated amortization	*JE*		25
Nov. 30	Sold 25 bonds @ 101	*CR*		25,250
	Other			
July 31	Sold 40 shares of Longwood, Inc. treasury stock @ 82 (purchased in 1965 at $80 per share—carried at cost)	*CR*		3,280
Dec. 29	Paid 1968 rental charge on safe deposit box used for investments	*CD*	35	
	Totals		$74,560	$41,890

All security purchases include brokers' fees and sales are net of brokers' fees and transfer taxes when applicable. The fair market values (net of brokers' fees and transfer taxes) for each security as of the 1967 date of each transaction were:

Security	*3/31*	*6/30*	*7/31*	*11/15*	*11/30*
Compudata common	48		60	61 1/4	62
Standard Atomic common	26	30			
Standard Atomic preferred		16 2/3	17		
Interstate Airlines bonds		102			101
Longwood, Inc. common			82		

Required:

Prepare a worksheet to distribute or correct each of the transactions entered in the Miscellaneous Assets account. Ignore income taxes in your solution. Formal adjusting entries are not required. Make separate entries for each transaction; do not combine adjustments. In addition to columns for entries in the Miscellaneous Assets account, the following column headings are recommended for your worksheet:

ADJUSTMENTS TO DISTRIBUTE AND CORRECT ITEMS ENTERED IN THE MISCELLANEOUS ASSETS ACCOUNT

Miscellaneous Assets Debit (Credit)	*Investments Debit (Credit)*	*(Gain) Loss from Sale of Investments*	*(Income) from Dividends & Interest*	*Other Accounts: Name of Account*	*Other Accounts: Debit (Credit)*

EXAMINATION IN COMMERCIAL LAW

November 8, 1968; 8:30 a.m. to 12:00 m.

All questions are required.

Number 1 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to **general principles of corporation law.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

An example of the manner in which the questions should be answered is shown in the following illustration:

Question

XX. The following elements are necessary to constitute a pledge:
1. Possession by the pledgor.
2. Property used to secure a loan or other obligation.
3. Either real or personal property.
4. A right of redemption retained by the pledgor.
5. Title retained by the pledgor.

Answer Sheet

1. False
2. True
3. False
4. True
5. True

Questions to be Answered

A. Frank, Mark and John joined together to promote the formation of Eagle Corporation to construct houses. The promoters contracted with Frank's brother-in-law, George, that the Corporation would purchase a tract of land owned by George for $100,000 to be paid six months after the Corporation was formed. The contract specifically provided that Frank, Mark and John would not incur any liability as promoters. After executing the contract the promoters completed incorporation through the purchase of stock at par for cash by the promoters and several of their friends and relatives. Mark and his three sons were elected as directors and hired as officers. The Corporation then had the land surveyed, had building plans drawn, and tendered $100,000 to George for the land.

1. Prior to the incorporation the promoters had no fiduciary duties.
2. Upon incorporation the promoters could satisfy any obligation to make a full disclosure of their activities to the Corporation by making such a disclosure to the board of directors.
3. The agreement made by the promoters with George did not constitute an enforceable contract at the time it was executed.
4. The Corporation could be regarded as a third party beneficiary of the contract between the promoters and George.
5. The actions of the officers of the Corporation would constitute an adoption of the contract between George and the promoters which would bind both George and the Corporation to the contract.

B. You have been the auditor of Cybul Corporation for the three years it has been in existence. Upon incorporation 1,000 shares of $50 par value common stock authorized by the articles of incorporation were sold for cash to the public. The Corporation was very profitable and the board of directors, which has as its members all of the officers of the Corporation, to reward management for outstanding work, has increased the salary of each officer by $5,000. The Corporation plans to expand its production facilities and issue more stock to obtain additional capital. To date the Corporation has paid no dividends.

6. The directors breached their duty to the shareholders by not declaring a dividend.
7. The directors must obtain shareholder approval to amend the certificate of incorporation prior to issuing additional shares of stock.
8. The directors may not effectively agree to raise the officers' salaries.
9. The directors may legally agree to allow themselves to have the first opportunity to subscribe to the additional shares of stock to be issued.
10. The general investing public must be offered a reasonable opportunity to purchase shares of the new stock to be issued when present shareholders are given an opportunity to purchase such shares.

C. David and Sidney each own 50 per cent of the capital stock of Diamond Corporation. They are unrelated and have no other business relationship. They entered into a shareholders' agreement which provided that upon the death of either, the survivor would purchase the other's stock in the Corporation at book value with the book value to be determined annually by a CPA. The book value of each party's stock interest as determined by a CPA on the date of the execution of the agreement was $20,000. David and Sidney plan to purchase life insurance on each other so that funds will be available to meet their obligations under the agreement.

11. The shareholders' agreement cannot remain valid for more than ten years unless it is renewed.
12. The shareholders' agreement may remain in effect even if David and Sidney fail to have a CPA annually review the book value of their stock interests.
13. If the premium to be paid by Sidney on the insurance policy he takes out on David's life is higher than the premium David must pay, Sidney is entitled to reimbursement for the additional cost from the Corporation.
14. If David should die the insurance proceeds Sidney collects would constitute a dividend.
15. If David and Sidney both sell their stock they could not take out additional insurance on each other's lives.

D. Your client, Plywood Corporation, a manufacturer, has consistently operated at a loss since its incorporation three years ago. Plywood is now insolvent and owes twenty creditors a total of more than $50,000. Stanley is a stockholder of Plywood and Walter owns bonds issued by Plywood which are now due. Most bondholders will not demand payment until conditions improve. Stanley demands that Plywood purchase his stock at his cost and Walter demands payment for his bonds. Each threatens to force Plywood into bankruptcy if his demand is not met. Stanley also owns stock in Hardwood Corporation, a very successful enterprise, and Hardwood has offered to purchase its own stock from Stanley at a price in excess of the market price of the stock.

16. Plywood may not repurchase Stanley's stock because it has a deficit balance in its legal capital.
17. Walter cannot alone file a petition for the involuntary bankruptcy of Plywood if Plywood refuses to retire Walter's bonds.
18. If Plywood repurchases Walter's bonds and immediately files a voluntary petition in bankruptcy, the trustee in bankruptcy may be able to claim that Walter received a preference.
19. Hardwood's stock would be "watered stock" if Hardwood should repurchase its own stock from Stanley for more than the market price.
20. Hardwood would commit an *ultra vires* act by repurchasing its own stock from Stanley.

E. Alan is chairman of the board of directors of Shipping Corporation, one of your clients. The by-laws of the Corporation provide for a seven-man board of directors, one of whom has just died. The by-laws have no provision for filling a vacancy and Alan would like to appoint his brother. Alan has also learned that two ships, the Nina and the Pinta, are available for purchase. Alan would like to purchase the Nina himself and attempt to sell it for profit and he thinks the Corporation should purchase the Pinta.

Alan attempted to telephone the other directors and inform them of what he learned and what he would like to do. He contacted two directors who agreed by telephone to all of his plans. A third director could not be reached. The fourth director agreed to Alan's plans on behalf of himself and the fifth director, who had given his proxy to the fourth director. The substance of the telephone calls was not reduced to writing.

21. Alan did not hold a valid director's meeting.
22. Alan, as chairman of the board of directors, does not have implied power to fill a vacancy on the board of directors.
23. Alan was free to purchase the Nina without disclosing his plans.
24. The director who could not be contacted will be strictly accountable for any wrong done by his fellow directors even though he was unaware of what was happening.
25. Directors have power to vote by proxy to the same extent as shareholders.

F. Evan and Norman each own 50 per cent of the capital stock of Eian Corporation. They arranged a conference with their lawyer and their accountant to agree on the terms of a stockholders' agreement. If agreed upon by both stockholders the following provisions could be properly adopted as a part of the stockholders' agreement.

26. The stockholders' agreement is to terminate if the Corporation's stock should be sold to the investing public.
27. The Corporation can be dissolved without court approval if the stockholders disagree.
28. A stockholder wishing to sell all or part of his stock in the Corporation must first offer the stock to the other stockholder at a price to be determined by an independent appraisal.
29. The sale of stock is to be restricted.
30. The activities in which the Corporation may engage under the terms of its charter are to be increased.

Number 2 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the **general principles of contract law.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. James Mann owns a manufacturing plant in which radios are assembled. A CPA conducting an audit determined that several radios were missing. Theft by one or more of the workers was suspected. Accordingly, under Mann's instructions, the following sign was placed in the employees' cafeteria:

"REWARD—I believe employees are stealing radios. I want all employees to watch other employees to see they do not steal. A reward of $500 will be paid for information given by any employee which leads to the apprehension of an employee who is stealing radios.

James Mann"

31. The posting of the sign constituted an offer to enter into a unilateral contract.
32. The posting of the sign constituted an irrevocable offer which will remain in effect for a reasonable period of time.
33. If an employee gave information which led to the apprehension of another employee who was stealing, the employee who gave the information may not collect the reward if he was not aware of the offer at the time he reported the other employee.
34. If an employee began to carefully observe his fellow employees to determine who was stealing, the act of observing would constitute partial acceptance of the offer of reward.
35. The offer of reward may be effectively revoked immediately upon the removal of the sign.

B. Albert orally ordered a $600 standard model television console for his home from Mastercraft Appliances. Mastercraft accepted the order and later sent Albert a purchase memorandum in duplicate with a request that Albert sign and return one copy. Albert did not sign or return the purchase memorandum and he refused to accept the television console. Mastercraft sued and Albert asserted the Statute of Frauds as a defense.

36. The purchase memorandum sent by Mastercraft will be sufficient to defeat Albert's reliance on the Statute of Frauds.
37. If Albert admits in court to making the oral contract, the contract will be enforceable.
38. A purchase memorandum will be insufficient to satisfy the Statute of Frauds if it omits any of the terms agreed to by the parties.
39. A writing sufficient to satisfy the Statute of Frauds would not be necessary if Albert had received and accepted the television console.
40. Specific performance is the only remedy Mastercraft can obtain in its suit against Albert.

C. Lester and Brookings entered into a written employment contract in January under which Lester promised to employ Brookings and Brookings promised to work for Lester as a bookkeeper for 1 year commencing on June 1 at a salary of $100 per week. In April Lester said to Brookings, "Unless business improves I am afraid I will not be able to keep my promise to employ you in June."

41. After hearing Lester's statement Brookings may immediately accept other employment without losing his right to enforce Lester's promise on June 1.
42. After hearing Lester's statement Brookings must be available for employment by Lester on June 1 or he will breach his contract if Lester wishes to hire him.
43. If prior to June 1 Brookings dies, his estate will not be liable to Lester for breach of contract.
44. If on June 1 Lester is unwilling to hire Brookings and Brookings is able to obtain a position as a stockboy for another employer at a salary of $100 per week, Brookings is under a duty to accept this employment

in order to mitigate the damages resulting from his not being hired by Lester.

45. If prior to June 1 Lester's only plant is shut down by government order Lester's obligation to hire Brookings is excused.

D. While verifying Jarman's liabilities a CPA learned that during 1967 Jarman contracted with Pauling to purchase Pauling's business. As a part of the purchase price Jarman promised to be responsible for all of Pauling's business debts outstanding on the date that Jarman assumed control of the business.

46. Jarman's promise to be responsible for Pauling's business debts could be enforced by Pauling's creditors.
47. Jarman's promise to be responsible for Pauling's business debts constitutes a novation.
48. If a misunderstanding arises as to the meaning of the term "business debts," the parol evidence rule would prevent the introduction of evidence of a subsequent oral agreement between Jarman and Pauling defining the term.
49. Although Jarman has agreed to be responsible for Pauling's business debts, Pauling would continue to remain liable to his creditors on such debts.
50. The contract to purchase the business would not be enforceable because the actual price to be paid for the business was uncertain at the time the contract was made.

E. Morrison's factory badly needed painting. Atkins, a painter in need of work, wrote to Morrison stating that unless Morrison objected by return mail Atkins would proceed to paint Morrison's factory with two coats of paint for the cost of the paint plus $2,000. The parties had not previously done business together.

51. If Morrison received Atkins' letter, tore it up and did not reply, Morrison's silence would not be an effective acceptance.
52. If Morrison effectively accepted Atkins' offer and Atkins refused to paint the factory, Morrison may successfully sue Atkins for specific performance and force him to paint his factory.
53. If Atkins commenced painting the factory with Morrison's approval and applied only one coat of paint, Atkins may rightfully demand payment of one half of the contract price if he needs money.
54. If Morrison effectively accepted Atkins' offer and the factory burned down before Atkins could commence painting, Atkins is not entitled to receive the $2,000 although he remains ready to paint the factory and cannot find other work.
55. If Atkins did not receive a reply from Morrison and proceeded to paint the factory, and Morrison (who did not know of Atkins' letter) returned from an extended vacation and was pleased to find his factory painted, Morrison would still not be responsible to Atkins in contract although he received a benefit which he needed and which cannot be returned.

F. The following letter on company letterhead was sent to Jones, a noted artist, by John Able, the president of Able Corporation which is your audit client:

"Dear Mr. Jones:

"My company offers you the opportunity of painting my portrait next month. The painting must be completed within 30 days after you start work and I must be completely satisfied with the result. If you meet both of these conditions my company will pay you your usual fee plus an additional $1,000. On the other hand, if you are not able to meet these conditions I will expect you to pay my company $500 because you will have wasted my time.

"If you do not effectively accept this offer by mail within 10 days from the date of this letter the offer shall no longer be in effect.

"Sincerely,
John Able, President"

56. If Jones mailed a properly stamped and addressed letter of acceptance to Able within 10 days of the date of Able's letter, an effective acceptance was made even if Jones' letter is never received.
57. If Jones effectively accepted Able's offer, began work on the painting but then saw that he could not complete it within 30 days, Jones may rightfully withdraw his acceptance of the offer in order to avoid being liable to Able Corporation for $500.
58. If Jones effectively accepted Able's offer but before starting to work obtained a much better offer from another source, Jones may delegate the painting of Able to his assistant provided Jones carefully supervises the work.
59. If Jones effectively accepts Able's offer, Able must cooperate with Jones to allow him to finish his work within the time allotted or Able will have breached the contract.
60. If Jones effectively accepted Able's offer and completed the work and Able in good faith was not completely satisfied with the finished painting, Jones must pay Able Corporation $500 even though a group of noted art critics found that the work was a remarkably good work.

Number 3 (Estimated time—20 to 25 minutes)

Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether **each** of the legal conclusions is true or false according to the provisions of **Article 2 (Sales) of the Uniform Commercial Code and general principles of law.** Write on a separate answer sheet whether each conclusion is true or false. Your grade will be determined from your total net score obtained by deducting your total of incorrect answers from your total of correct answers; an omitted answer will not be considered an incorrect answer.

Questions to be Answered

A. Franklin purchased a new Wizard automobile from Superior Auto Sales, Inc., the local Wizard dealer. The contract of sale was silent on the question of warranty protection except for the following clause:

"The actual buyer of this automobile is the only person entitled to any warranty protection arising from the sale by Superior Auto Sales, Inc. of this Wizard automobile."

Franklin was aware of this provision at the time he purchased the automobile.

Several days later the automobile collided with an oncoming truck. Franklin, his wife, and their maid were injured. The collision also caused extensive damage to the automobile. It was conclusively determined that the collision was caused by a faulty part in the Wizard's steering mechanism.

61. If Franklin returned the automobile to Superior Auto Sales, Inc. and received his money back, his action would constitute an election to rescind and would preclude recovery of damages.
62. Mrs. Franklin will be precluded from recovering from Superior Auto as a result of the clause limiting warranty protection to the actual buyer.
63. Even if the contract did not contain the clause limiting warranty protection, the maid would be precluded from suing Superior Auto because of lack of privity.
64. The Uniform Commercial Code expressly permits a purchaser of a product purchased from a local sales representative to sue the manufacturer of the product.
65. Since Superior Auto's contract of sale did not contain any express warranty protection, recovery can only be obtained if negligence is proven.

B. Martin purchased an earth-mover from the Strong Equipment Company. The written contract contained a detailed description of the capabilities of the equipment under varying conditions. In addition the contract conspicuously stated: "There are no warranties which extend beyond the description contained herein."

66. Martin received an express warranty by description.
67. The parol evidence rule would be asserted against Martin if he attempted to rely upon an oral express warranty made prior to the execution of of the contract and which added to the description of the earth-mover's capabilities.
68. An implied warranty of fitness was effectively excluded by the above disclaimer.
69. An implied warranty of merchantability was excluded by the above disclaimer.
70. If the contract of sale had contained language clearly indicating that the earth-mover was sold "as is," Martin would lose all implied warranty protection.

C. Parker ordered 50 cartons of soap flakes from Riddle Wholesale Company. Each carton contained 12 packages of soap flakes. The terms were: Eight dollars per carton, 2/10, net/30, F.O.B. buyer's delivery platform, delivery by June 1.

During transit approximately one half the packages were damaged as a result of being crushed by other merchandise being carried by the local motor carrier. The delivery was made on May 28.

71. Riddle had the risk of loss during transit.
72. If Parker elects to accept the undamaged part of the shipment, he will be deemed to have accepted the entire shipment.
73. To validly reject the goods, Parker must give timely notice of rejection to Riddle within a reasonable time after delivery.
74. If Riddle were notified of the rejection on May 28, Riddle could cure the defect by promptly notifying Parker of its intention to do so and making a second delivery to Parker of conforming goods by June 1.
75. The Statute of Frauds is inapplicable to the transaction in the facts given in "C."

D. Johnston, a retail appliance dealer, agreed to buy 25 color television sets from Reliable T.V. Manufacturing Company. The sets were promptly delivered and according to the terms of the contract Johnston was granted the right to return any or all of the sets within one month from the date of delivery. The contract was otherwise silent on the type of sale contemplated and the question of risk of loss.

Two weeks after receipt of the sets Johnston's storage area was flooded, severely damaging 20 of the sets shipped by Reliable T.V. The flooding was not due to any negligence on Johnston's part. Johnston seeks to return the 20 damaged sets.

76. Johnston would prevail if he could persuade the court that the transaction was a "sale or return."
77. According to the facts given, the transaction should be categorized as a "sale on approval."
78. If Reliable T.V. retained a non-possessory security interest in the T.V. sets, the risk of loss to the extent of such security interest will be placed upon Reliable T.V.
79. Unless Johnston had title to the T.V. sets he would not have a valid insurable interest in them.
80. If Johnston elected to return the 5 sets which were not damaged, the return would be at the buyer's expense.

E. Andrews wished to purchase a second-hand calculator. He saw the model he wanted on sale at the Addito Calculator Company showroom. The salesman indicated that the price did not include delivery and that Andrews would have to take it with him or have it picked up within two days because storage space was scarce at Addito. Andrews agreed to these terms, signed the contract and said he would pick up the calculator the next day.

The Addito salesman marked the calculator "sold," placed Andrews' name on it and moved it to the storeroom. That night thieves broke into the storeroom and removed all items, including the calculator in question. This was in no way caused by the negligence of Addito. Andrews refuses to pay unless he receives the calculator. Addito claims the sale had been consummated, that title had passed, and Andrews therefore must pay the agreed price.

81. Title is irrelevant in determining who bears the risk of loss in the above transaction.
82. Because Addito is a merchant, risk of loss does not pass to Andrews until he receives the calculator.
83. Andrews would have to pay for the calculator if the contract had expressly provided that Andrews would bear the risk of loss from the time the contract was signed.
84. If Andrews had agreed to pick up the calculator the afternoon of the sale and failed to do so, the risk of loss would rest with Andrews to the extent that the calculator was not effectively covered by Addito's insurance.
85. If the contract had contained the delivery term, F.O.B., place of delivery, Addito would be unable to collect the purchase price.

F. Smart, a used car dealer, showed a 1967 automobile to Giles. Smart told Giles, "In my opinion the car is a dandy buy for the money, a real honey, and a car you would be happy owning." Smart honestly believed these statements.

Giles liked the looks of the car but insisted on a trial run and personal inspection. Giles knew very little about automobiles. He drove the car at varying speeds and examined the usual things an unsophisticated buyer would ordinarily inspect. He could find nothing wrong with the car and bought it. The car had an almost invisible hairline crack in the engine block at the time of sale.

The contract of sale contained a disclaimer clause which stated: "The buyer expressly waives all warranty protection afforded him in connection with the purchase of this automobile." This clause was in fine print in the middle of the seventh page of the contract. Giles was not aware of it at the time of the purchase.

86. Smart's sales talk constituted an express warranty.
87. The fact that Smart honestly believed the statements he made in connection with the sale was irrelevant insofar as Giles' warranty protection is concerned.
88. The disclaimer described above is invalid.
89. Giles will be precluded from recovering for breach of warranty as a result of his test drive and inspection.
90. If Giles cannot recover for breach of warranty, he can recover damages based upon fraud.

Number 4 (Estimated time—20 to 25 minutes)

Jarrett Corporation is a manufacturer of folding boxes which it sells to bakeries. Cooks Bakery was indebted to Jarrett in the amount of $500 and Cooks' manager suggested to Jarrett's bookkeeper that Cooks be allowed to satisfy the obligation by negotiating to Jarrett a certified check in the amount of $500 which Cooks had received from a customer.

The bookkeeper examined the check and found that it was drawn four days before on The National Bank by Richard Smith and was payable to the order of Donald Jones. Cooks' manager explained that J & H Caterers received the check from Jones in payment for a catered party and that J & H Caterers had refused to take the check from Jones unless it was first certified. Jones obtained the certification from The National Bank, which stamped the words "certified payable as originally drawn" on the face of the check. The check was then indorsed by Jones to J & H Caterers, who in turn properly indorsed the check to Cooks. With knowledge of the facts Jarrett's bookkeeper agreed to accept the check. The check was properly indorsed by Cooks and delivered to Jarrett's bookkeeper.

Jarrett's bookkeeper then cashed the check at The National Bank. Later the bank called and demanded the return of $400, explaining that the check had been originally issued for $100, that the check had been stamped "certified as originally drawn," and that it had been raised by Jones to $500 prior to certification. The bank agreed with Jarrett's bookkeeper that no one but an expert would have realized that the check had been raised.

Required:

a. Is Jarrett Corporation a holder in due course? Explain, including a description of the requirements for a holder in due course in your answer.

b. What was the amount and the nature of Smith's liability, if any, on the check after it was certified by The National Bank at the request of Jones? Explain.

c. For the purpose of examining the financial statements of Jarrett Corporation, should a CPA consider that the check is worth $500 or worth only $100? (Is it necessary that Jarrett record a liability of $400 to The National Bank?) Explain.

Number 5 (Estimated time—25 to 30 minutes)

Part a. Easy Credit Corporation made a personal loan to Whitworth after Acme Surety Company agreed to serve as his surety for an appropriate fee. Subsequently, Whitworth defaulted on the loan and disappeared. After his disappearance it was discovered that Whitworth had fraudulently misrepresented the extent of his assets to both Easy Credit and Acme Surety. Easy Credit seeks to collect from Acme Surety on the surety undertaking. Acme Surety asserts the defense of fraud and refuses to pay.

Required:

Will the defense of fraud prevail against Easy Credit? Explain.

Part b. Mason Supply Company required its customers to provide guarantors of collection if a customer's credit standing was not satisfactory. While auditing Mason's books a CPA discovered that several of the customers were in arrears on their accounts. Mason wishes to proceed against the various guarantors.

Required:

1. How does a guaranty of collection differ from the usual surety undertaking? Explain.
2. What steps must be taken by Mason in order to collect from each guarantor? Explain.

Part c. Saxon was the surety on a building contract between Palmer Construction Company and Carleton. Saxon had the privilege of completing the building if Palmer should default. The contract also stipulated that any payments after default would be made directly to Saxon when the building was completed.

Palmer incurred losses in the construction and defaulted. Saxon then spent $100,000 to complete the building and received $115,000 in payments from Carleton. Palmer asserts a claim to the profit.

Required:

Is Saxon entitled to the entire $115,000? Explain.

Part d. George owed money to Marsh, and Wilson was the surety on George's debt. Still feeling insecure, Marsh obtained Fairfax as a subsurety on Wilson's undertaking. George defaulted and Marsh seeks recovery on the surety undertakings.

Required:

1. What rights does Marsh have against Wilson? Explain.
2. What rights does Marsh have against Fairfax? Explain.
3. Assuming Fairfax pays Marsh in full, what rights does Fairfax have against Wilson? Explain.

Part e. Simon was the surety on a $1,000 debt owed by Phillips to Charles. To insure that Phillips would satisfy the obligation, Simon held $800 of Phillips' securities as collateral. Phillips became insolvent and fraudulently obtained a written release from Charles which he used to obtain the securities from Simon. Charles learned of the fraud, rescinded the release and notified Simon of the fraud. Phillips has disappeared and Charles is attempting to enforce the surety undertaking against Simon.

Required:

What is the effect of the fraudulently obtained release on Simon's surety undertaking? Explain.

Number 6 (Estimated time—20 to 25 minutes)

Part a. Johnson was a general partner in a machine tool merchandising partnership. Johnson applied for a personal loan at Empire Loan Company. The intended purpose of the loan, as disclosed by Johnson to Empire, was to purchase a new automobile for his wife. Empire refused to lend Johnson the money unless an accommodation indorsement by his firm was obtained. Johnson signed his name on the face of the note and then signed the firm name on the back. All this was done in the presence of the Empire agent.

Johnson is now bankrupt and Empire seeks to collect from the partnership or alternatively to obtain Johnson's interest in the partnership.

Required:

1. Can Empire hold the partnership liable on the note? Explain.
2. Can Empire obtain Johnson's interest in the partnership? Explain.
3. What effect does Johnson's bankruptcy have upon the partnership?

Part b. Bradley and Smith are the only partners in an insolvent partnership. The firm has assets of $10,000 and liabilities of $100,000. The creditors are Donaldson ($50,000), Charles ($40,000), and Williams ($10,000). The three creditors rank equally in order of priority. Bradley does not have any personal assets or liabilities. Smith has personal assets of $80,000 but he owes the Security Bank $50,000. Smith has no other personal debts.

Required:

How much are Donaldson, Charles, Williams and Security Bank each entitled to receive? Explain.

Part c. Upon examining the books of account of a partnership you ascertain the following facts:

1) The partnership was created six months ago and consists of three partners, Monroe, Adams and Madison, who share profits equally. The partnership agreement is silent on the sharing of losses.
2) Monroe loaned the partnership $10,000 and made a capital contribution of $20,000; Adams made a $10,000 capital contribution; Madison made no capital contribution.
3) The partnership now has assets of $80,000 and owes outside creditors $55,000.
4) The partners have decided to dissolve the firm.

Monroe requests that you explain how the distribution should be made to the partnership's creditors and its partners. He is particularly concerned about his own rights on dissolution.

Required:

Prepare the explanation requested above. Give the reasons for the conclusions you reach.

Number 7 (Estimated time—25 to 30 minutes)

A CPA examining the financial statements of Excellent Storm Window Company seeks to determine the collectibility of a $300 past due account receivable from Evans. He is given the following information:

Martin, a general home contractor, was authorized by Excellent to solicit orders for storm windows. Evans told Martin that he wanted storm windows and Martin showed him Excellent's brochure and contract form for ordering storm windows. The contract form contained prices and specifications and indicated that Excellent was the seller. The contract order form contained several provisions and clearly specified that "storm windows are sold as is without any warranty, express or implied, unless a warranty is requested from Excellent's home office and received in writing from an authorized agent."

Evans reviewed the form and asked Martin to install windows costing $300 after Martin said, "As an experienced general contractor I personally warrant that these storm windows will do the job." Martin completed the form properly and Evans executed the form. Within a short time Martin personally delivered and installed the storm windows.

After the windows were installed, Evans, following Martin's instructions, gave Martin a check, payable to his order, for $300. Martin cashed the check and disappeared without fulfilling his obligation to remit payment to Excellent. Under Martin's contract with Excellent, he had no authority to collect payment and Excellent maintains therefore that Evans is still responsible for payment. Evans, on the other hand, has informed the Company that he is not responsible for payment and that he intends to hold Excellent liable because the windows are not adequate for his needs although the storm windows Martin installed do meet the specifications indicated on the contract form.

Required:

a. Identify the legal relationship between Martin and Excellent Storm Window Company.

b. May Evans validly disclaim liability to Excellent on the basis that he has already made payment to Martin? Explain.

c. Assume that Evans has correctly determined that the storm windows he received are not adequate for his needs. Does Evans have a cause of action against Excellent which should be reflected in Excellent's financial statements?

d. If Evans agrees to purchase a new set of storm windows from Excellent, can he demand that he be allowed to return the storm windows he received and obtain full credit toward the purchase of the new windows?

Number 8 (Estimated time—20 to 25 minutes)

Arnold purchased land from Barton for $100,000, made an initial payment of $25,000 and gave Barton a mortgage for the remainder of the purchase price to be paid in monthly installments. The mortgage required that any sale of the land while it was encumbered by the mortgage must have Barton's approval.

After Arnold obtained title, Carlton offered to purchase the land and assume the mortgage. Both Arnold and Barton agreed to the terms of the purchase and title was transferred to Carlton. Subsequently Carlton was unable to make the payments to Barton.

Required:

a. Contrast the legal significance of "assuming" a mortgage on property as compared with taking property "subject to" a mortgage.

b. Describe the legal relationship and the rights and duties of Carlton and Arnold resulting from Carlton's assumption of the mortgage.

c. Upon default, how can Barton assert a right to payment against Carlton when in fact Carlton never promised Barton anything?

EXAMINATION IN THEORY OF ACCOUNTS

November 8, 1968; 1:30 to 5:00 p.m.

All questions are required.

Number 1 (Estimated time—25 to 30 minutes)

Instructions

The following statements pertain to cost accounting, budgeting, and the control of operations through the use of cost data. Complete each statement by selecting the best answer choice for each item. Write the appropriate letter on a separate answer sheet. Select only one answer for each item.

An example of the manner in which the questions should be answered is shown in the following illustration:

Question

XX. Job order cost accounting is a method for determining the cost of items
  a. Where production is a continuous process.
  b. Which are indistinguishable from any other items produced.
  c. Where each item is unique in specialized production.
  d. When an estimated cost system is employed.

Answer Sheet

XX. c.

Questions to be Answered

1. A company employing very tight (high) standards in a standard cost system should expect that
   a. Costs will be controlled better than if lower standards were used.
   b. Employees will be strongly motivated to attain the standards.
   c. No incentive bonus will be paid.
   d. Most variances will be unfavorable.

2. Standard costing will produce the same results as actual or conventional costing when standard cost variances are distributed to
   a. Cost of goods sold.
   b. An income or expense account.
   c. Cost of goods sold and inventories.
   d. A balance sheet account.

3. The effect on a company's income before taxes of discontinuing a department with a contribution to overhead of $16,000 and allocated overhead of $32,000 of which $14,000 cannot be eliminated would be to
   a. Decrease income before taxes by $2,000.
   b. Decrease income before taxes by $18,000.
   c. Increase income before taxes by $2,000.
   d. Increase income before taxes by $16,000.

4. A budget variance (spending variance) for overhead is the difference between actual overhead cost and overhead cost that should have been incurred for the actual hours worked and results from
   a. Price differences for overhead costs.
   b. Quantity differences for overhead costs.
   c. Price and quantity differences for overhead costs.
   d. Differences caused by production volume variation.

5. A production manager did better-than-expected in controlling cost when $72,000 of expense was incurred during a period in which the expense was budgeted at $80,000 and the expense was a
   a. Variable cost and actual production was 90 per cent of budgeted production.
   b. Variable cost and actual production was equal to budgeted production.
   c. Depreciation charge which reduced because of the removal of machinery.
   d. Variable cost and actual production was 80 per cent of budgeted production.

6. The concept of "the ideal capacity of a plant" as used in cost accounting is its
   a. Theoretical maximum capacity.
   b. Best capacity for normal production.
   c. Capacity used for standard costing.
   d. Capacity below which production should not fall.

7. Flexible budgeting is a reporting system wherein the
   a. Budget standards may be adjusted at will.
   b. Reporting dates vary according to the levels of activity reported upon.
   c. Statements included in the budget report vary from period to period.
   d. Planned level of activity is adjusted to the actual level of activity before the budget comparison report is prepared.

8. Manufacturing overhead should be allocated on the basis of
   a. An activity basis which relates to cost incurrence.
   b. Direct labor hours.
   c. Direct labor cost.
   d. Direct machine hours.

9. The term "relevant range" as used in cost accounting means the range
   a. Over which costs may fluctuate.
   b. Over which cost relationships are valid.
   c. Of probable production.
   d. Over which relevant costs are incurred.

10. Process cost accounting is the method to be used in assigning costs to products
   a. Which are manufactured on the basis of each order received.
   b. Which are only partially completed during the accounting period.
   c. As an average cost per unit for all units in process during the accounting period.
   d. When standard cost accounting is not used in a continuous process manufacturing facility.

11. Overapplied overhead will always result when a predetermined overhead rate is employed and
   a. Production is greater than defined capacity.
   b. Actual overhead costs are less than expected.
   c. Defined capacity is less than normal capacity.
   d. Overhead incurred is less than overhead applied.

12. The difference over a period of time between actual overhead and applied overhead will usually be minimal when the predetermined overhead rate is based on
   a. Normal (or practical) capacity.
   b. Designed capacity.
   c. Direct labor hours.
   d. Direct machine hours.

13. If a predetermined overhead rate is not employed and the volume of production is reduced from the level planned, the cost per unit would be expected to
   a. Remain unchanged for fixed costs and increase for variable costs.
   b. Increase for fixed costs and remain unchanged for variable costs.
   c. Increase for fixed costs and decrease for variable costs.
   d. Decrease for fixed costs and decrease for variable costs.

14. Management by exception refers to management's
   a. Having no predetermined plan.
   b. Considering only rare events.
   c. Taking action on items selected at random.
   d. Considering only items which vary materially from plans.

15. As applied to cost accounting, a cost center is a
   a. Unit of activity for which costs are accumulated.
   b. Cost accounting department.
   c. Plant accounting department.
   d. Production department.

16. A joint cost must be allocated
   a. To by-products.
   b. On the basis of costs after separation.
   c. On an authoritatively selected but consistently applied basis.
   d. On the basis of selling price of all products.

17. Absorption costing differs from direct costing in the
   a. Amount of costs assigned to individual units of product.
   b. Amount of net income that will be reported when there is no change in inventory.
   c. Amount of fixed costs that will be incurred.
   d. Kinds of activities for which they may be used to report.

18. An understatement of work in process inventory at the end of a period will
   a. Understate cost of goods manufactured in that period.
   b. Overstate current assets.
   c. Overstate gross profit from sales in that period.
   d. Understate net income for that period.

19. Profit-volume analysis is most important for the determination of the
   a. Volume of operation necessary to break even.
   b. Relationship between revenues and costs at various levels of operations.
   c. Variable revenues necessary to equal fixed costs.
   d. Sales revenue necessary to equal variable costs.

20. Reporting under the direct costing concept is accomplished by
    a. Including only direct costs in the income statement.
    b. Matching variable costs against revenues and treating fixed costs as period costs.
    c. Treating all costs as period costs.
    d. Eliminating the work in process inventory account.

Number 2 (Estimated time—25 to 30 minutes)

In 1948 a new partnership purchased land on the edge of the town of Midville, erected a building and opened a furniture and appliance merchandising store under the name of Furniture Fair. The partnership agreement specified that profits or losses would be shared equally after the allocation of partners' salary allowances and interest on average capital balances.

Midville has grown considerably and the store is now the most prominent in a fashionable suburban area. Good management, imaginative merchandising and the general increase in the economy have made Furniture Fair the leading and most profitable firm of its type in Midville's trade area.

Now the partners wish to admit an investor and incorporate the business and have obtained a charter for Furniture Fair, Inc. Each partner will purchase at par an amount of preferred stock equal to the book value of his interest in the partnership and common stock equal to that portion of the fair market value which exceeds the book value. The investor will purchase at a ten per cent premium over par value common and preferred stock equal to one third the number of shares of each purchased by the partners. The Corporation will then purchase the Furniture Fair partnership at its fair market value from the partners. After the consummation of the partners' plan the Corporation will own the partnership's assets, assume its liabilities, and employ the partners as the management of the Corporation.

Required: (Consider only financial reporting. Do not consider income tax reporting):

a. List and explain the differences in items and valuations that you would expect to find between the assets to appear on the balance sheet of the proposed corporation and the assets which appear on the partnership's balance sheet.

b. List and explain the differences that would be expected in a comparison of an income statement prepared for the proposed corporation and an income statement prepared for the partnership.

Number 3 (Estimated time—25 to 30 minutes)

The controller's staff of the Metairie Publishing Corporation prepared the following statement for the annual report to stockholders:

Metairie Publishing Corporation

STATEMENT OF FINANCIAL POSITION

December 31, 1967

Current assets:		
Cash, including time deposits	$ 8,000	
Marketable securities, at cost	13,000	
Notes receivable, face amount (note 1)	21,000	
Net accounts receivable, including assigned accounts	40,000	
Inventories, at lower of cost or market	100,000	$182,000
Less current liabilities:		
Accounts payable	$ 51,000	
Notes payable	15,000	
Income taxes payable	20,000	
Accrued interest on notes (note 1)	1,100	87,100
Net working capital		$ 94,900
Noncurrent assets:		
Receivable from long-term lease (note 2)	$ 70,000	
Property, plant and equipment less accumulated depreciation of $74,000	255,700	
Deferred income tax charges on advance advertising and subscription revenue	11,000	336,700
Total net working capital and noncurrent assets		$431,600
Less long-term liabilities:		
Unearned advertising contracts	$ 80,000	
Subscriptions received in advance	22,000	
6% debentures, payable in ten equal annual installments beginning July 1, 1968	110,000	
Deferred income tax credits relating to accelerated depreciation	16,000	228,000
Total net assets		$203,600
Claims to net assets by stockholders:		
Preferred stock		$ 40,000
Common stock		80,000
Retained earnings		83,600
Total claims to net assets		$203,600

Notes to the Statement of Financial Position:

1. Notes receivable include $10,000 of notes which do not provide for interest. The Corporation has included in the accrued interest on notes $800 which represents the difference between the present value and maturity value of the non-interest bearing notes receivable.
2. The financing method of accounting for leased property is used.

Required:

Identify and discuss the weaknesses in presentation, disclosure and classification in the above Statement of Financial Position. Your discussion should explain why you consider the items to be weaknesses and what you consider to be their proper treatment. Do not prepare a revised statement. Assume the arithmetic is correct.

Number 4 (Estimated time—25 to 30 minutes)

In recent years distribution expenses of the Avey Company have increased more than other expenditures. For more effective control the Company plans to provide each local manager with an income statement for his territory showing monthly and year-to-date amounts for the current and the previous year. Each sales office is supervised by a local manager; sales orders are forwarded to the main office and filled from a central warehouse; billing and collections are also centrally processed. Expenses are first classified by function and then allocated to each territory in the following ways:

Function	*Basis*
Sales salaries	Actual
Other selling expenses	Relative sales dollars
Warehousing	Relative sales dollars
Packing and shipping	Weight of package
Billing and collections	Number of billings
General administration	Equally

Required:

a. 1. Explain responsibility accounting and the classification of revenues and expenses under this concept.
   2. What are the objectives of profit analysis by sales territories in income statements?

b. 1. Discuss the effectiveness of Avey Company's comparative income statements by sales territories as a tool for planning and control. Include in your answer additional factors that should be considered and changes that might be desirable for effective planning by management and evaluation of the local sales managers.
   2. Compare the degree of control that can be achieved over production costs and distribution costs and explain why the degree of control differs.
   3. Criticize Avey Company's allocation and/or inclusion of (a) other selling expenses, (b) warehousing expense and (c) general administration expense.

Number 5 (Estimated time—25 to 30 minutes)

Sudan Corporation needs additional funds for plant expansion. The board of directors is considering obtaining the funds by issuing additional short-term notes, long-term bonds, preferred stock or common stock.

Required:

a. What primary factors should the board of directors consider in selecting the best method of financing plant expansion?

b. One member of the board of directors suggests that the Corporation should maximize trading on equity, that is, using stockholders' equity as a basis for borrowing additional funds at a lower rate of interest than the expected earnings from the use of the borrowed funds.

1. Explain how trading on equity affects earnings per share of common stock.
2. Explain how a change in income tax rates affects trading on equity.
3. Under what circumstances should a corporation seek to trade on equity to a substantial degree?

c. Two specific proposals under consideration by the board of directors are the issue of 7% subordinated income bonds or 7% cumulative, nonparticipating, nonvoting preferred stock, callable at par. In discussing the impact of the two alternatives on the debt to stockholders' equity ratio, one member of the board of directors stated that he felt the resulting debt-equity ratio would be the same under either alternative because the income bonds and preferred stock should be reported in the same balance sheet classification. What are the arguments (1) for and (2) against using the same balance sheet classification in reporting the income bonds and preferred stock?

Number 6 (Estimated time—25 to 30 minutes)

Opinion Number 11 issued by the Accounting Principles Board states that except in unusual circumstances no recognition should be given to the tax benefit of a loss carryforward until this tax benefit is actually realized.

Recognition of the benefit would create an asset.

Required:

a. 1. Explain the concept of an asset as the term is used within generally accepted accounting principles.
2. Discuss the circumstances under which it is proper to recognize the benefit from a tax loss carryforward as an asset.

b. Whether or not a tax loss carryforward should be a determinant of net loss of the loss period must be decided by weighing two accounting concepts.

1. Under what conditions should the concept of conservatism prevail?
2. Under what conditions should the going concern concept prevail?

c. Deferred tax credit accounts may exist at the time a net loss is sustained. If the resulting tax loss carryforward does not enter into the determination of net loss of the loss period, explain for each period indicated below (a) the accounting treatment the deferred tax credit accounts should receive, (b) the reasons this treatment should be applied and (c) the effects of this treatment on the financial statements in

1. The loss period.
2. A subsequent accounting period in which a benefit from the loss carryforward is realized.

Number 7 (Estimated time—25 to 30 minutes)

You have been engaged to examine the financial statements of Custer Corporation for the year ending December 31, 1968. Custer Corporation was organized in January 1968 by Messrs. Moses and Price, original owners of options to acquire for $350,000 oil leases on 5,000 acres of land. They contemplated that first the oil leases would be acquired by the Corporation and subsequently 180,000 shares of the Corporation's common stock would be sold to the public at $6 per share. In February 1968 they exchanged their options, $150,000 cash and $50,000 of other assets for 75,000 shares of common stock of the Corporation. The Corporation's board of directors appraised the leases at $600,000 based on other acreage recently leased in the same area. The options were therefore recorded at $250,000 ($600,000-$350,000 option price).

The options were exercised by the Corporation in March 1968 prior to the sale of common stock to the public in April 1968. Leases on approximately 500 acres of land were abandoned as worthless during the year.

Required:

a. Why is the valuation of assets acquired by a corporation in exchange for its own common stock sometimes difficult?

b. 1. What reasoning might Custer Corporation use to support valuing the leases at $600,000, the amount of the appraisal by the board of directors?

2. Assuming the board's appraisal was sincere, what steps might Custer Corporation have taken to strengthen its position to use the $600,000 value and to provide additional information if questions are raised about possible overvaluation of the leases?

c. Discuss the propriety of charging one-tenth of the recorded value of the leases against income at December 31, 1968 because leases on 500 acres of land were abandoned during the year.

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